Financial Services & Products ADVISORY ■

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Federal Banking Agencies Issue Dodd–Frank Mandated Report on Bank Activities and Investments

On September 8, 2016, the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) issued a 107-page joint report to Congress and the Financial Stability Oversight Council (FSOC) pursuant to Section 620 of the Dodd–Frank Wall Street Reform and Consumer Protection Act on the activities and investments that banking entities may engage in under state and federal law. The report is intended to identify bank activities and investments that could pose a threat to the safety and soundness of banking entities and the U.S. financial system, the risks associated with the activities and investments, and how banking entities mitigate those risks.

The Dodd–Frank Act required the agencies to submit the report to Congress within 18 months of enactment (which was July 21, 2010), but the agencies failed to meet that deadline by more than four years. The report was subject to lengthy delays as the agencies struggled to finalize many of the approximately 400 rules mandated by the Dodd–Frank Act (some of which still have not been finalized or even proposed).

The Federal Reserve, FDIC and OCC each independently prepared its portion of the report. Each section sets forth a discussion of permissible activities and investments, including associated risks, applicable risk mitigation and legal limitations, and provides specific recommendations, as required by the Dodd–Frank Act.

High Level Observations

The report reveals the scope of the agencies' discretionary authority and their appetite for making substantive changes to permissible bank activities and investments. For example, the Federal Reserve looks to Congress to make statutory changes, such as a repeal of the power of financial holding companies to engage in merchant banking activities. The OCC relies upon the scope of its existing regulatory authority, and in fact has already moved to make changes, such as a proposal to limit commodities activities in base metals. The FDIC, on the other hand, declines to make substantive recommendations beyond further study.

While the banking regulators' recommendations are particularly germane to large financial holding companies, banks and thrifts, some of the policy proposals, such as the OCC's revisions to permissible investment rules and recommendation for prudential standards for commodities swaps activities, could affect smaller firms.

There is a long history of regulatory antipathy to the industrial loan company (ILC) exemption. However, the Federal Reserve's recommendation to repeal a federal exemption that currently allows commercial firms to acquire ILCs could have a significant impact on emerging FinTech business models that leverage the ILC charter and the federal exemption.

State-chartered banking entities should be aware of the OCC's recommendations regarding permissible activities and investments of national banks and federal savings associations because state-chartered banks and savings associations are generally limited to engaging in activities and making investments that are permissible for national banks, with some exceptions.

Federal Reserve

In its portion of the report, the Federal Reserve provides an overview of the scope of its current jurisdiction over U.S. bank holding companies (BHCs), savings and loan holding companies (SLHCs), financial holding companies (FHCs), state member banks, Edge Act and agreement corporations, the international operations of U.S. BHCs, and the U.S. operations of foreign banking organizations. The Federal Reserve described the evolution of permissible non-banking activities of such organizations, including through significant statutes such as the BHC Act, the Home Owners' Loan Act, the Gramm–Leach–Bliley Act (GLBA) and the Dodd–Frank Act, and also discussed interpretive policy limits adopted by the Federal Reserve.

The GLBA expanded the scope of permissible activities for FHCs to include "financial" activities such as insurance underwriting and agency, securities underwriting and dealing (repealing the last remnants of the Glass–Steagall Act), securities brokerage, merchant banking, insurance portfolio investments and activities determined to be incidental or "complementary" to these financial activities. In addition, the GLBA grandfathered certain physical commodities activities of certain FHCs. However, the Federal Reserve highlights that in each instance, Congress also emphasized that permissible non-banking activities of banking entities should not undermine safety and soundness, and has repeatedly reaffirmed a fundamental structural separation of banking from commerce.

In the report, the Federal Reserve provides charts outlining various structural statistics. Notably, only 11 percent of BHCs (and only 3 percent of SLHCs) have elected to become FHCs and to gain the power to engage in a wider array of financial activities. Further, while all BHCs with greater than $250 billion in assets have elected to be FHCs, the proportion of BHCs making that election declines in rough correlation to the asset size of the institutions.

Following the GLBA, the Federal Reserve has found certain activities to be "complementary" to permissible financial activities for FHCs, reflecting congressional intent that FHCs would not be disadvantaged by commercial firms competing with FHCs in commercial activities that evolved into financial activities. For example, the Federal Reserve has approved, subject to certain conditions and limits on size and scope, trading in physical commodities (including taking and making delivery in connection with certain derivatives transactions), energy tolling and energy management services, and disease management and mail-order pharmacy activities. Further, under GLBA grandfathering authority, two firms (Morgan Stanley and Goldman Sachs) have been permitted to engage in an expanded set of physical commodities activities, such as owning properties and facilities engaged in oil or mineral extraction, subject to certain statutory limits.

The Federal Reserve describes at length the existing limitations on FHC activities that ensure safety and soundness. These include supervisory ratings qualifications; enhanced risk-based capital standards (in particular for large, complex and internationally active FHCs); enhanced prudential standards for capital, liquidity and risk management; enhanced supervision of the largest, most complex banking organizations; targeted and horizontal reviews of certain activities (such as physical commodities activities); structural limits on transactions with the FHC's affiliated depository institution; and the Federal Reserve's supervisory authority over insurance and broker-dealer firms within the FHC structure. The Federal Reserve previously issued an advance notice of proposed rulemaking in January 2014 as a result of its horizontal review of the commodities investments and activities permitted to FHCs, which signaled its views in this area.

Federal Reserve recommendations

Despite the range of prudential limits already in place in the existing framework of law, in the report the Federal Reserve recommends statutory changes. Underpinning the recommendations is the fundamental tenet of separation of banking and commerce to support the safety and soundness of banking entities and to avoid application of the federal safety net to commercial firms.

- ***Repeal the authority of FHCs to engage in merchant banking activities.*** Because it involves what might otherwise be considered "controlling" investments in commercial firms (up to 100 percent), merchant banking activities permissible for FHCs are subjected to particular scrutiny under existing law, including an array of prudential limits, potential capital charges and prescribed monitoring and recordkeeping standards to ensure that FHCs can account for the potential "catastrophic and environmental events" that could arise from merchant banking portfolio companies if corporate separateness is not maintained. However, the Federal Reserve asserts that the ability of FHCs under existing law to engage in routine management of a portfolio company to obtain a reasonable return on disposition subjects the FHC to unreasonable levels of risk of legal claims.
- ***Repeal Section 4(o) of the BHC Act.*** This step would repeal the grandfathered authority under the GLBA for certain FHCs (specifically, Morgan Stanley and Goldman Sachs) to engage in commodities activities, such as owning properties and facilities engaged in oil or mineral extraction, subject to certain statutory limits. The Federal Reserve asserts that this authority raises legal liability concerns, lacks any regulatory approval requirements and does not reflect a level playing field with other FHCs that are permitted to engage in a more limited set of physical commodities activities under "complementary" authority.
- ***Repeal the exemption that permits corporate owners of ILCs to operate outside of the regulatory and supervisory framework applicable to other corporate owners of insured depository institutions.*** ILCs are state-chartered entities also supervised by the FDIC that have broad authority similar to that of commercial banks, including access to deposit insurance and the discount window. However, they are exempt from the definition of a "bank" under the BHC Act, and so commercial firms that acquire

an ILC are not subject to the BHC Act, are not subject to consolidated capital requirements and are not required to act as a source of strength to the ILC. The Federal Reserve asserts that this exemption violates the separation of banking and commerce, permits regulatory arbitrage and fosters an uneven playing field, including for community banks that engage in similar activities. Further, the ILC exemption permits commercial firms (and foreign banking organizations) to own depository institutions without being subject to consolidated supervision or subject to requirements as FHCs that the company be well-managed and well-capitalized, and that the depository institution have a satisfactory Community Reinvestment Act rating.

- ***Repeal the exemption for grandfathered unitary SLHCs from the activities restrictions applicable to all other SLHCs.*** Grandfathered unitary SLHCs are those SLHCs that are commercial firms permitted to continue engaging in commercial activities under an exemption in the GLBA. Similar to the repeal of the ILC exemption, the Federal Reserve asserts that this exemption violates the separation of banking and commerce and fosters an uneven playing field that allows such firms to operate without the same restrictions as other similarly situated firms.

FDIC

In its portion of the report, the FDIC summarizes the statutory framework for permissible non-banking activities and investments of state nonmember banks and savings associations, including under the Federal Deposit Insurance Act (FDI Act) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Broadly, the FDICIA expanded the scope of permissible activities for these institutions by amending the FDI Act to permit activities that are not permissible for national banks and federal savings associations. Under the FDI Act, the FDIC must make a determination that the proposed activity would pose no threat to the Deposit Insurance Fund. Further, pursuant to the GLBA, the FDI Act provides that an insured nonmember state bank may engage through a subsidiary in certain activities as permitted to a “financial subsidiary” of a national bank (broadly, “financial activities” other than merchant banking and insurance underwriting).

Part 362 of the FDIC’s regulations governs all applications to engage in any such activities as principal, with certain requirements pertaining to all insured state banks and savings associations, and others applicable only to state nonmember banks. For purposes of the report, the FDIC reviewed 430 of the filings that were submitted to the FDIC under Part 362 since 1994, a substantial majority of which were requests to engage in various real-estate-related activities and investments. (The FDIC notes that many of these applications would not be required today, due to changes in the activities permissible for national banks and their subsidiaries.) A sizeable portion of other filings dealt with equity-related activities and investments and investments associated with mineral rights. Interestingly, only 2 percent of the Part 362 notices reviewed pertained to insurance activities.

Real estate

Insured nonmember state banks have been permitted by the FDIC, under certain circumstances and subject to certain capital limitations, to develop, hold, lease and invest in real estate and to own real estate beyond the 10-year statutory limit applicable to national banks if it is acquired pursuant to a debt previously contracted. The FDIC describes real estate investment as having a high degree of market risk and, for real estate development investments, additional risk related to completion of projects within specified costs and time limits. These risks are mitigated by various restrictions and conditions imposed by the FDIC on real-estate-related activities and investments as well as guidance for insured state nonmember bank activities.

Equity securities

Since the enactment of the FDICIA, the FDIC has permitted insured nonmember state banks and their subsidiaries to engage in a broad range of activities involving investments in equity securities. Risks are mitigated by various restrictions and conditions imposed by the FDIC on equity investments in securities, including a risk management program commensurate with the bank's size, complexity and investment activities. These risks are also mitigated by the regulatory capital rules, which contain certain capital deductions and heightened risk weights for equity investments, and by the Volcker rule, which generally restricts proprietary trading in securities, including structured products that are securities, and generally prohibits banking entities from having an ownership interest in "covered funds."

Mineral rights

Insured nonmember state banks are permitted, in certain circumstances, to indirectly engage in activities or investments related to mineral interests. Given distinctions in state law, the majority of the filings received by the FDIC related to mineral rights were related to requests to establish wholly-owned subsidiaries to hold and manage the mineral rights connected to or severed from real estate acquired in connection with debts previously contracted. Mineral rights interests are subject to specialized risks, including potential liability under general common law, environmental law and specific oil and gas production law. These risks are mitigated by various restrictions and conditions imposed by the FDIC on mineral-interests-related activities and investments, by maintaining a separate corporate existence from their subsidiaries, beneficial terms of lease agreements, indemnification and insurance policies or bonds.

Insurance

Insured nonmember state banks are permitted to purchase and hold bank-owned life insurance (BOLI) policies on directors, officers and employees, hold an annuity issued by an insurance company and conduct specified insurance activities through wholly-owned subsidiaries or third-party service providers. Risks are mitigated by various restrictions and conditions imposed by the FDIC on insurance-related activities and investments, including for BOLI activities pursuant to the Interagency Statement on the Purchase and Risk Management of Life Insurance.

Other activities

The FDIC has also permitted insured state banks to engage in other activities pursuant to Part 362, including investments, leasing, derivatives and securities underwriting.

FDIC recommendations

Based on its review of these activities and investments, the FDIC does not recommend any legislative action. Rather, the FDIC identifies areas for enhancement, reconsideration and clarification. Specifically, the FDIC will:

- Review activities related to investments in other financial institutions and other equity investments to evaluate the interaction of existing FDIC regulations under Part 362 with other more recent regulatory and statutory rules in order to determine whether changes to Part 362 are necessary.
- Determine whether the prudential conditions and standards under which the FDIC evaluates Part 362 filings involving mineral rights, commodities or other nontraditional activities need to be clarified and enhanced.

OCC

In its portion of the report, the OCC provides an overview of the scope of its jurisdiction under existing law regarding national banks, federal savings associations and federal branches and agencies of foreign banks. The OCC determined that derivatives, physical commodities, securities and structured products warranted special focus in the OCC's review. As a result of its review, the OCC states that it is not recommending any legislative action, but plans to:

- Clarify minimum prudential standards for certain national bank-swap-dealing activities.
- Consider providing guidance on clearinghouse memberships.
- Clarify regulatory limits on physical hedging.
- Limit national banks' authority to hold and trade copper.
- Incorporate the Volcker Rule into the OCC's investment securities rules.
- Issue a proposed rule that restricts national banks from holding asset-backed securities, which may be backed by bank-impermissible assets, as Type III securities, and to issue an analogous proposed rule for federal savings associations.
- Address concentrations of mark-to-model assets and liabilities with a rulemaking or guidance.

Derivatives

National banks may engage in derivative transactions with payments based on bank-permissible holdings, and federal savings associations may engage in financial derivatives if authorized to invest in the underlying assets. National banks may also deal in derivatives that reference rates or assets permissible for bank investment and, with prior written OCC non-objection, national banks may deal in derivatives on other rates and assets as part of a customer-driven financial intermediation business. However, national banks may not conduct a proprietary trading business in these derivatives. In addition, national banks may be members of securities and commodity exchanges and clearinghouses, the rules of which may require members to assume liability for other members' defaults. A national bank may assume this liability if certain conditions are met. Federal savings associations may be clearing members of securities exchanges that allow members to limit their liability for other members' defaults.

The OCC identifies price, interest rate, liquidity and credit risks specific to derivatives, but notes that the Dodd–Frank Act (in particular, the Volcker Rule and Title VII of the Dodd–Frank Act), capital standards, heightened risk management requirements and other measures have substantially reduced these risks. Based on its review of derivatives activities, the OCC recommends taking the following actions:

- Clarifying minimum prudential standards applicable to national banks engaged in certain swap-dealing activities in order to ensure that national banks establish a prudent control framework for their swaps dealing.
- Reviewing the risks posed by memberships in clearinghouses, especially those with rules that do not limit members' liability, and evaluate whether guidance is appropriate.

Physical commodities

National banks are authorized to buy and sell "exchange, coin and bullion," which has been construed to include gold, silver, platinum, palladium and copper. National banks may also purchase and sell title to physical commodities, within limits, to hedge commodity price risk in connection with permissible customer-driven commodity derivative transactions. Federal savings associations may not speculate in precious metals, but they may carry immaterial positions in order to facilitate customer trades. Federal savings associations are not authorized to hold physical commodities for hedging or other purposes. The chief risks identified by the OCC as associated with these physical commodities activities are price and operational risk, which are mitigated by the OCC's stringent limits on physical hedging. Current precedent limits physical hedges to 5 percent of a national bank's hedging activity. However, precedents do not specify calculation methodology. In 2015, the OCC published supervisory guidance for this purpose.

Based on its review of physical commodities activities, the OCC recommends publishing a *Federal Register* notice soliciting comment on whether the OCC should treat copper as a base metal, define "coin and bullion" in a manner that excludes copper cathodes and conclude that buying and selling copper is generally not part of or incidental to the business of banking, as it is also characterized as a base metal.[1]

Securities

National banks may purchase "investment securities" (marketable debt obligations that are investment grade and not predominantly speculative in nature), subject to limitations and restrictions imposed by the OCC. Investment securities are classified into five types. National banks may also invest in debt securities that are not investment securities in two ways. First, under the reliable estimates authority, a national bank may treat a debt security as an investment security if it is marketable and the bank concludes, based on reliable estimates, that the obligor will be able to satisfy its obligations under the security. The aggregate par value of these securities must be 5 percent or less of the bank's capital and surplus. Second, a national bank may purchase a debt security under its express authority to discount and negotiate evidences of debt. Debt securities acquired under this authority are considered loans, and legal lending limits apply.

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1 On the same day that the report was published, the OCC issued a proposed rule to prohibit national banks and federal savings associations from dealing and investing in industrial or commercial metals. The proposal covers metal, including alloy, in a physical form primarily suited to industrial or commercial uses. Examples include copper cathodes and aluminum T-bars.

The OCC has also determined by analogy that federal savings associations may use their lending authority to purchase certain securities.

Generally, national banks and federal savings associations are prohibited from making equity investments, but there are various exceptions. National banks may own equity securities and debt securities for hedging purposes under certain circumstances, may acquire equity securities as a result of debts previously contracted and may also underwrite and deal in certain types of investment securities. Further, national banks may privately place securities and engage in securities brokerage activities.

The chief risks identified by the OCC as associated with these securities investments and activities are interest rate, credit and liquidity risk. These risks are significantly mitigated by the Volcker Rule and the OCC's enhancements to capital standards. In addition, as a result of the Dodd–Frank Act, banks may not rely exclusively on credit ratings to determine that a security is investment grade and therefore a permissible investment.

However, the OCC recommends that its investment securities regulations be updated to reflect the restrictions in the Volcker Rule. These changes would clarify that the Volcker Rule supersedes any contrary authority in the OCC regulations applicable to national banks and federal savings associations, and any investments made pursuant to those regulations would also need to be in compliance with the Volcker Rule. As an example, "covered funds" investments would only be permissible as provided under exemptions in the Volcker Rule.

Structured products

National banks are permitted to purchase certain asset-backed securities for investment. Federal savings associations may invest in structured products backed by assets in which they could directly invest or to the extent that the products are investment grade and marketable debt securities. A national bank may securitize and sell its assets, whether the bank originated them or purchased them, and may market these securities, serve as the securitization trustee, service the underlying loans, serve as payment agent and provide liquidity and credit support to issuers of structured products. A federal savings association may securitize and sell assets in which it may invest, whether originated by the federal savings association or purchased from others.

Structured products are derivatives or securities, so they have the risks inherent in any derivative or security, including interest rate, credit and liquidity risks. These risks are mitigated by the risk retention rule in Section 941 of the Dodd–Frank Act, which requires securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells or conveys to a third party. The risks are also mitigated by the Volcker Rule and the Dodd–Frank Act's ban on reliance on credit ratings.

Based on its review of structured products investments and activities, the OCC recommends the following:

- The OCC will propose guidance or a rulemaking to address the potential risks posed by concentrations in mark-to-model assets and liabilities. Because many structured products have no ready market price and are difficult to value, banks often rely on pricing models to mark structured products; and under relevant accounting principles, many of these products are marked to fair value each day, creating price risk. The OCC has concerns about banks developing concentrations of assets and liabilities that are subject to fair value accounting on a recurring basis, where fair value is based solely on internal models that rely on management assumptions, and about concentrations of mark-to-model assets or liabilities because of the subjectivity inherent in valuing mark-to-model positions. The OCC suggests it could develop a rule or guidance that (1) requires robust oversight programs to control the size and scope of the portfolio of mark-to-model assets and liabilities throughout the economic cycle; and (2) clearly articulates the remedial actions that must be taken when concentrations of mark-to-model assets and liabilities that exceed risk tolerances develop.

- The OCC is considering not allowing national banks to hold asset-backed securities, which may be backed by bank-impermissible assets, as Type III securities. Type III securities are investment securities that are not Type I, II, IV or V, so they are somewhat of a catch-all. The most common types of Type III securities are investment-grade corporate bonds and investment-grade sovereign bonds. The OCC believes it may be more appropriate to determine permissibility of investments in asset-backed securities by reference to the underlying assets, as is the case with Type V securities, because the credit quality of asset-backed securities depends heavily on the underlying assets. This approach would prevent a national bank from investing in an asset-backed security backed by bank-impermissible assets solely by concluding that the security is investment grade and marketable. National banks would still be able to buy asset-backed securities that meet the standards for Type I, II, IV or V securities.
- Similarly, the OCC is considering not allowing federal savings associations to hold asset-backed securities as corporate debt securities if the assets include assets that are impermissible for federal savings associations. Federal savings associations would still be able to invest in certain asset-backed securities (such as GSE-guaranteed mortgage-backed securities) under other authority.

Conclusion

While the federal banking agencies shared a purpose in preparing their individual sections of the report—to identify bank activities and investments that could pose a threat to the safety and soundness of banking entities and the U.S. financial system—the recommendations offered by the Federal Reserve, FDIC and OCC were vastly different in nature. It will likely be some time until we are able to see how Congress responds to the agencies' recommendations, particularly those of the Federal Reserve, which called for extensive legislative action. The FDIC's "further study" approach left us with little clear indication of where the FDIC stands on the appropriateness of non-banking activities and investments under existing laws. The OCC's recommendations include items that the OCC can implement without any need to involve Congress, and the OCC has already issued some related proposed rules and guidance. Yet, perhaps the greatest indicator of the impact of the report will be how the industry responds to the report and the agencies' recommendations in order to protect competing interests among various groups such as differing charters, large versus small institutions and other competing interests within the industry.

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