Client Alert

September 9, 2016

Federal Banking Agencies Issue Recommendations as Part of Their Section 620 Report to Solidify the Safety and Soundness of the U.S. Financial System

On September 8, 2016, the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC," and together with the Federal Reserve and the FDIC, the "Federal Banking Agencies") issued their report pursuant to Section 620 (the "Section 620 Report") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). In accordance with Section 620 of the Dodd-Frank Act, the Federal Banking Agencies are required to conduct a study of the activities and investments that banking entities may engage in under state and federal law for the purpose of providing recommendations regarding:

- Whether the activities or investments have (or could have) a negative effect on the safety and soundness of the banking entities or the U.S. financial system at large;
- The appropriateness of the conduct of the activities or types of investment by banking entities; and
- Additional restrictions, as necessary, to address risks to safety and soundness arising from the permissible activities or types of investment or banking activities.

While some of the recommendations offered by the Federal Reserve, the FDIC and the OCC are tailored to ameliorate the risks associated with the types of entities they each regulate, the Federal Banking Agencies articulate the same overarching goal of maintaining the safety and soundness of the U.S. financial system and curtailing the types of permissible, albeit risky, activities that served as the impetus for the financial crisis of 2008.

This alert is divided into two parts. Part I provides a detailed overview of the recommendations provided in the Section 620 Report by each of the Federal Banking Agencies. Part II contains a summary chart, which provides a high-level overview of the recommendations provided by each of the Federal Banking Agencies and the particular entity (or entities) that would be impacted should the recommendation be implemented.

Part I. Recommendations Made by the Federal Banking Agencies

The following section provides a detailed overview of the Federal Banking Agencies' recommendations contained in the Section 620 Report.

a. Recommendations Made by the Federal Reserve

The Federal Reserve proposed to implement several statutory changes that would eliminate special exemptions that permit certain firms to operate free of activities restrictions and/or outside of the prudential framework applicable to other banking entities.[1] The Federal Reserve asserts that its recommended changes, as discussed in

[1] *See* Federal Reserve, FDIC and OCC, "Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act" (Sept. 2016), at 28, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160908a1.pdf.

greater detail below, would better align the activities and investments of, as well as the supervisory framework governing, certain regulated financial institutions and corporate owners of insured depository institutions ("IDIs").[2] Moreover, these changes would "create a more level playing field among regulated financial institutions and owners of [IDIs]" as well as enhance the safety and soundness of the U.S. financial system by "limit[ing] the commercial activities of banking entities" and consequently, an institution's ability to "take on risk associated with commercial activities."[3]

Given that the Federal Reserve cannot implement these changes through unilateral regulatory action, the Federal Reserve has called upon the U.S. Congress to repeal:

- the authority of financial holding companies ("FHCs") to engage in merchant banking activities;
- the grandfathered authority for certain FHCs to engage in commodities activities under Section 4(o) of the Bank Holding Company Act of 1956 (the "BHC Act");
- the exemption that permits corporate owners of industrial loan companies ("ILCs") to operate outside of the regulatory and supervisory framework applicable to other corporate owners of IDIs; and
- the exemption for grandfathered unitary savings and loan holding companies ("GUSLHCs") from the activities restrictions applicable to other savings and loan holding companies ("SLHCs").

Repeal FHCs' Ability to Engage in Merchant Banking. First, the Federal Reserve recommends that FHCs lose their ability to engage in merchant banking activities. Under current merchant banking authority, specifically the Gramm-Leach-Bliley Act (the "GLBA"), FHCs may make investments in nonfinancial companies as part of a *bona fide* merchant or investment banking activity. While the Federal Reserve believes that it has taken regulatory action to limit the potential risks associated with merchant banking activities, the existing statutory authority enables an FHC to engage in activities that would pose significant risks to the FHC's safety and soundness. For example, FHCs may own up to 100% of the ownership interest of a nonfinancial portfolio company or be involved in the routine management of the company, and therefore, be exposed to the risk of legal liability for the operations of a portfolio company. Accordingly, repealing the current merchant banking statutory framework would "address potential safety and soundness concerns and maintain the basic tenet of separation of banking and commerce."[4]

Repeal of Section 4(o) of the BHC Act. Second, the Federal Reserve recommends the repeal of Section 4(o) of the BHC Act, with an appropriate transition to permit affected firms with sufficient time to wind down their existing commodity activities.[5] Section 4(o) of the BHC Act is a grandfather provision that has permitted two FHCs to engage in a broad range of activities related to physical commodities (including the storage, transportation and extraction of commodities). However, the Federal Reserve asserts that this grandfather provision raises safety and soundness concerns as well as competitive issues because it is only available to two FHCs.[6] Given that Section 4(o) of the BHC Act does not prohibit FHCs from engaging in, operating or investing in commodities facilities for the production of commodities, FHCs may be exposed to strict liability, under certain federal environmental laws, arising from environmental catastrophes, creating material financial and legal harm for these firms as well as harming public confidence in (and access to) funding markets for the firm (or its subsidiary IDI). Moreover, by providing only two FHCs with the ability to engage in physical commodities activities, these firms are able to enjoy an advantage through the ability to obtain important information on conditions in the physical markets. Lastly, Section 4(o) of the BHC Act also undercuts the separation of banking and commerce by enabling certain FHCs to engage in a broader range of commercial activities outside the financial domain.

[2] *Id.* at 29.
[3] *Id.*
[4] *Id.* at 31.
[5] *Id.* at 30.
[6] *Id.* at 29.

Repeal the Exemptions for GUSLHCs and Corporate Owners of ILCs. Third, the Federal Reserve proposes the repeal of exemptions for GUSLHCs and corporate owners of ILCs from requirements under the BHC Act and the Home Owners' Loan Act ("HOLA"). ILCs are state-chartered banks that have virtually all of the powers and privileges of other insured commercial banks, but are nonetheless not included within the BHC Act's definition of "bank."[7] GUSLHCs are unitary SLHCs that were already in existence before the passage of the GLBA, and therefore, permitted to continue to operate without activity restrictions under the BHC Act or HOLA.[8]

The BHC Act and HOLA provide for all BHCs and SLHCs to be supervised on a consolidated or group-wide basis by the Federal Reserve. Moreover, the BHC Act and HOLA prevent BHCs and SLHCs from engaging in general commercial activities—BHCs and SLHCs may only engage in activities that Congress or the Federal Reserve has determined to be financial in nature, or incidental or complementary to a financial activity. Lastly, the BHC Act and HOLA require as a condition for engaging in broad securities underwriting, insurance and other financial activities that an FHC (and its depository institution subsidiary) meet enhanced financial and managerial standards—the depository institution subsidiary must additionally maintain a satisfactory performance under the Community Reinvestment Act.

However, the exemptions provided to GUSLHCs and corporate owners of ILCs from the requirements under the BHC Act and HOLA undermine several fundamental policies that Congress has established (and reaffirmed) governing the structure, supervision and regulation of the financial system. Moreover, the exemptions provide GUSLHCs and corporate owners of ILCs with a competitive regulatory playing field by enabling these entities to "operate outside of activity restrictions . . . that apply to other community-based, regional and diversified organizations that own a similarly situated bank."[9] Accordingly, by repealing the exemptions for GUSLHCs and corporate owners of ILCs from these requirements under the BHC Act and HOLA, the Federal Reserve states that this will only further help protect the safety and soundness of the U.S. financial system and maintain the general separation of banking and commerce in the United States.

b. Recommendations Made by the FDIC

Based on the review of the activities in which state banks and state savings associations may engage, the FDIC has made the below recommendations for the purposes of enhancing, reconsidering and clarifying several areas of the policies and procedures currently provided under Part 362 of the FDIC's regulations ("Part 362").

Changes to Regulations and Supervisory Approvals. First, the FDIC intends to review activities related to investments in other financial institutions and other equity investments to determine whether the interaction of existing FDIC regulations and supervisory approvals and conditions, as currently stipulated under Part 362, should be changed in light of more recent regulatory and statutory rules governing such investments.[10]

Changes to Prudential Conditions and Standards. Second, the FDIC plans to determine whether the prudential conditions and standards under which the FDIC will evaluate Part 362 filings related to mineral rights, commodities or other nontraditional activities need to be clarified, and whether a statement of policy pursuant to such a review is necessary.

c. Recommendations Made by the OCC

The OCC made the following recommendations in the Section 620 Report, all of which are discussed in greater detail below:

- Clarify minimum standards for derivative dealing;[11]
- Review federal banking entities' risk management of clearinghouse memberships;[12]

[7] *Id.* at 7-8.
[8] *Id.* at 32.
[9] *Id.* at 32-33.
[10] *Id.* at 74.
[11] *Id.* at 85.

- Address copper trading and appropriate limits;[13]
- Clarify physical hedging limits;[14]
- Incorporate the "Volcker Rule" into the OCC's investment regulations;[15]
- Address concentrations of mark-to-model assets and liabilities;[16]
- Reconsider allowing national banks to purchase asset-backed securities as "Type III" securities;[17] and
- Reconsider allowing federal savings associations to purchase asset-backed securities as corporate debt securities.[18]

Clarify Minimum Standards for Derivative Dealing. First, the OCC proposed to clarify the minimum prudential standards applicable to national banks engaged in certain swap dealing activities. The OCC believes that such a clarification is needed because smaller national banks have expressed a growing interest in establishing and expanding its swap dealing businesses (including commodity swaps). However, there is currently no prudential control framework in place ensuring that these national banks engage in these swap dealing activities in a safe and sound manner.

Review Federal Banking Entities' Risk Management of Clearinghouse Memberships. Second, the OCC is currently reviewing the risks to federal banking agencies posed by being members in clearinghouses—specifically, those clearinghouses with rules that fail to place a cap on members' liability. The OCC will also assess whether guidance on clearinghouse membership is necessitated.

Address Copper Trading and Appropriate Limits. Third, the OCC proposed to consider whether copper should be subject to the same limits and reporting requirements that apply to other base metals. The OCC has previously issued an interpretation that copper falls within national-bank permissible coin and bullion activities. However, unlike gold, silver, platinum and palladium, which are all deemed "precious metals," copper is characterized as both a precious metal and base metal. Accordingly, the OCC plans to solicit for comment in the *Federal Register* whether the OCC should: (i) treat copper as a base metal; (ii) define "coin and bullion" in a manner that excludes copper cathodes; and (iii) conclude that buying and selling copper is generally not part of (or incidental to) the business of banking.

Clarify Physical Hedging Limits. Fourth, the OCC recommends the clarification of existing limits on physical hedges. Current precedents require that physical hedges "be a 'nominal' portion of a national bank's hedging activity."[19] While the OCC has established that 5% is deemed "nominal," precedents fail to specify how national banks should specifically calculate how much of their hedging involves physical settlement.

Incorporate the Volcker Rule into the OCC's Investment Securities Regulations. Fifth, the OCC intends to update its investment securities regulations, including 12 C.F.R. § 1 (for national banks) and 12 C.F.R. § 160 (for federal savings associations), so that the restrictions under the Volcker Rule, and its implementing regulation, are applicable to national banks and federal savings associations. Moreover, these changes would clarify that the Volcker Rule supersedes any contrary authority under 12 C.F.R. § 1 and 12 C.F.R. § 160.

Address Concentrations of Mark-to-Model Assets and Liabilities. Sixth, the OCC expressed its concerns with "federal banking entities 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

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[12] *Id.* at 86.
[13] *Id.* at 89-90.
[14] *Id.* at 90.
[15] *Id.* at 99
[16] *Id.* at 105-106.
[17] *Id.* at 106.
[18] *Id.* at 107.
[19] *Id.* at 90.

assumptions."[20] Specifically, federal banking entities with concentrations of mark-to-model assets create supervisory concerns due to the subjectivity inherent in valuing market-model positions—this subjectivity makes it difficult to assess a federal banking entity's true risk profile and consequently their capital adequacy. Accordingly, the OCC will propose guidance or a future rule to address the potential risks that are generated by significant concentrations in mark-to-model assets and liabilities.

Reconsider Allowing National Banks to Purchase Asset-Backed Securities as Type III Securities. Seventh, the OCC is considering whether national banks should be prohibited from holding as Type III securities asset-backed securities, which may be backed by bank-impermissible assets. Type III securities are investment securities that do not fall within the definition of a Type I,[21] Type II,[22] Type IV[23] or Type V[24] security. The OCC states that because the credit quality of asset-backed securities depends heavily on the underlying assets, the cash flow rules and the structure of the security itself, it may be more appropriate to determine the permissibility of investments in asset-backed securities by reference to the underlying assets (as is currently done for Type V securities). Such an approach would ensure that a national bank is prevented from investing in an asset-backed security backed by bank-impermissible assets solely by determining that the security is investment grade and marketable.[25]

Reconsider Allowing Federal Savings Associations to Purchase Asset-Backed Securities as Corporate Debt Securities. Lastly, the OCC is considering prohibiting federal savings associations from holding as corporate debt securities asset-backed securities. The OCC's concerns over a federal savings association being able to purchase asset-backed securities as corporate debt securities is similar to the concerns over national banks purchasing asset-backed securities as Type III securities—specifically, assessments of asset-backed securities' credit quality depend heavily on the underlying assets.

[20] *Id.* at 105-106.
[21] "Type I securities" are securities that national banks may deal in, underwrite, purchase and sell. They need not be investment grade and are not subject to the 10% capital limit. These securities include, among others: (i) obligations of the United States; (ii) state and municipal limited obligations and revenue bonds (if the bank is well capitalized); and (iii) securities issued or guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac. *See* Section 620 Report, *supra* note 1, at 91.
[22] "Type II securities" are investment securities that national banks may deal in, underwrite, purchase and sell, subject to the 10% capital limit, including obligations of certain international and multilateral development banks, the Tennessee Valley Authority and the U.S. Postal Service. *See* Section 620 Report, *supra* note 1, at 91.
[23] "Type IV securities" include: small-business-related securities; commercial mortgage-related securities and residential mortgage-related securities. *See* Section 620 Report, *supra* note 1, at 100.
[24] "Type V securities" are investment grade, marketable securities (other than Type IV securities) that are fully secured by interests in loans to numerous obligors and in which a national bank could invest directly. *See* Section 620 Report, *supra* note 1, at 100.
[25] *Id.* at 106.

Part II. <u>Summary Chart</u>

Summary of Recommendations Provided in Section 620 Report		
Federal Banking Regulator	***Recommendation***	***Types of Entities Impacted***
FEDERAL RESERVE	• Repeal the authority of FHCs to engage in merchant banking.	• FHCs
	• Repeal the grandfather authority for certain FHCs to engage in commodities activities pursuant to Section 4(o) of the BHC Act.	
	• Repeal the exemption that permits owners of ILCs to operate outside of the regulatory and supervisory framework applicable to owners of IDIs.	• Corporate owners of ILCs
	• Repeal the exemption for grandfathered GUSLHCs from the activities restrictions applicable to other SLHCs.	• GUSLHCs
FDIC	• Review activities related to investments in other financial institutions and other equity investments to determine whether the interaction of existing FDIC regulations should be changed (under Part 362).	• State banks • State savings associations
	• Determine whether the prudential conditions and standards related to mineral rights, commodities or other nontraditional activities needs to be clarified, and a statement of policy needs to be issued.	
OCC	• Clarify minimum standards for derivative dealing.	• National banks
	• Review federal banking entities' risk management of clearinghouse memberships.	• Federal banking entities
	• Address copper trading and appropriate limits.	• National banks
	• Clarify physical hedging limits.	• National banks
	• Incorporate the "Volcker Rule" into the OCC's investment regulations.	• National banks • Federal savings associations
	• Address concentrations of mark-to-model assets and liabilities.	• Federal banking entities
	• Reconsider allowing national banks to purchase asset-backed securities as "Type III" securities.	• National banks
	• Reconsider allowing federal savings associations to purchase asset-backed securities as corporate debt securities.	• Federal savings associations

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