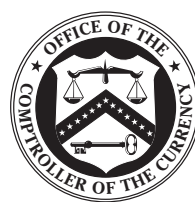


# Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act

Board of Governors of the Federal Reserve System

Federal Deposit Insurance Corporation

Office of the Comptroller of the Currency



# Report Pursuant to Section 620 of the Dodd–Frank Act

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## Introduction

The Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) prepared this report pursuant to section 620 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank).<sup>1</sup>

Section 620 requires the federal banking agencies to conduct a study of the activities and investments that banking entities<sup>2</sup> may engage in under state and federal law. In carrying out the study, the federal banking agencies are required to review and consider (i) the type of permissible activities and investments of banking entities; (ii) the risks, including financial, operational, managerial, or reputational, associated with or presented as a result of such activities or investments; and (iii) the risk mitigation activities undertaken by banking entities with regard to such risks.

After completion of the study, the agencies must prepare a report that includes recommendations regarding (i) 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, (ii) the appropriateness of the conduct of the activities or types of investment by banking entities, and (iii) additional restrictions as may be necessary to address risks to safety and soundness arising from the permissible activities or types of investments of banking entities. As the statute requires, the agencies are providing this report to the Committee on Financial Services of the U.S. House of Representatives, the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate, and the Financial Stability Oversight Council (FSOC).

The report contains three sections. The Board prepared the first section, which covers state member banks, depository institution holding companies, Edge Act and agreement corporations, and the U.S. operations of foreign banking organizations (FBO). The FDIC prepared the second section, which covers state nonmember banks and state savings associations. The OCC prepared the third section, which covers national banks, federal savings associations, and federal branches and agencies of foreign banks. Each section discusses activities and investments of the banking entities the agency regulates and supervises, including associated risks, applicable risk mitigation activities and legal limitations, and specific recommendations.

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<sup>1</sup> Pub. L. No. 111-203 (July 21, 2010). The agencies are referred to collectively in this report as “the federal banking agencies” or “agencies.”

<sup>2</sup> Section 620 defines the term “banking entity” by cross-reference to section 619. Subject to an exception for trust institutions, the term means any insured depository institution, any company that controls an insured depository institution or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (IBA), and any affiliate or subsidiary of any such entity. 12 USC 1851(h)(1).

# Section I: Federal Reserve

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The Federal Reserve has supervisory and regulatory authority over a wide range of firms that are defined as banking entities for purposes of section 620 of Dodd–Frank. In particular, the Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies (BHC), including financial holding companies (FHC), and state-chartered commercial banks that are members of the Federal Reserve System (state member banks). The Federal Reserve also supervises the operations of all Edge Act and agreement corporations, the international operations of state member banks and U.S. BHCs, and the U.S. operations of FBOs. In addition, Dodd–Frank transferred authority for consolidated supervision of more than 400 savings and loan holding companies (SLHC) and their nondepository subsidiaries from the Office of Thrift Supervision (OTS) to the Federal Reserve.<sup>3</sup>

The Federal Reserve is responsible for ensuring the safety and soundness of the banking entities it supervises and carries out this responsibility through the exercise of its supervisory and regulatory authority. The Federal Reserve carries out its mandate to ensure the safety and soundness of these entities through examinations; the development and implementation of supervisory policy (rulemakings, supervision and regulation letters, policy statements, and guidance); review and approval or denial of proposed expansions of activities and operations including mergers; enforcement of applicable laws and regulations; and ongoing staff development to meet evolving supervisory responsibilities. The Federal Reserve also employs macroprudential policy tools that are designed to increase the resilience of banking entities, which help reduce vulnerabilities in the financial system.<sup>4</sup>

The Federal Reserve employs a risk-focused framework for supervising the banking entities for which it is responsible. Under this framework, the Federal Reserve’s supervision of a banking entity focuses on those areas that pose the greatest risk to the soundness of the institution and to U.S. financial stability. The risk-focused supervisory process is designed to be dynamic and forward-looking so that the Federal Reserve can respond to changes in the condition of individual institutions and developments in the market, such as product innovation, technological advances, and new risk-management techniques. The process also is designed to reduce regulatory burden and duplication.

This section of the report focuses on activities and investments of banking entities subject to Federal Reserve regulation and supervision with a focus on activities and investments authorized pursuant to the Gramm–Leach–Bliley Act (GLBA).<sup>5</sup> The GLBA significantly expands the

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<sup>3</sup> The Federal Reserve also has supervisory and regulatory authority for nonbank financial firms and financial market utilities designated by the FSOC as systemically important. These organizations are not “banking entities” for purposes of section 620 of Dodd–Frank.

<sup>4</sup> See, e.g., Federal Reserve System, “Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer,” 81 Fed. Reg. 5661 (February 3, 2016) (proposed policy statement).

<sup>5</sup> Pub. L. No. 106-102, 113 Stat. 1338 (1999).

permissible activities and investments for many of the Board-regulated banking entities to include activities that are financial in nature such as (i) securities underwriting and dealing, (ii) insurance underwriting and agency activities,<sup>6</sup> and (iii) merchant banking activities that involve the investment in, and potential ownership of, nonfinancial companies and products.<sup>7</sup>

## **General Overview of Activities and Investments of Banking Entities Regulated by the Federal Reserve**

### **Activities and Investments of BHCs**

The Bank Holding Company Act (BHC Act), enacted in 1956, provides a statutory framework for the supervision and regulation of most domestic and foreign companies that control an insured depository institution.<sup>8</sup> In addition to protecting the safety and soundness of corporately controlled banks, a principal purpose underlying the BHC Act is ensuring the separation of banking from commerce.<sup>9</sup> To this end, the BHC Act limits the expansion of BHCs into nonbanking activities. Specifically, section 4 of the BHC Act generally prohibits a BHC from acquiring “ownership or control of . . . any company which is not a bank” or engaging “in any activity other than those of banking or of managing or controlling banks and other subsidiaries authorized under th[e] Act.”<sup>10</sup> The BHC Act provides certain limited exceptions for investments and activities related to owning and controlling banks. For example, BHCs are permitted to acquire shares of a nonbank company or nonbanking assets in satisfaction of debt previously

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<sup>6</sup> 12 USC 1843(k)(4)(B) and (E).

<sup>7</sup> 12 USC 1843(k); 12 USC 1843(o).

<sup>8</sup> The activities and investments that BHCs are permitted to engage in are prescribed by the BHC Act. The Board’s Regulation Y (12 CFR 225) and Regulation K (12 CFR 211) represent the comprehensive regulatory implementation of the various provisions of the BHC Act that govern the activities of BHCs, including FHCs.

<sup>9</sup> See S. Rep. No. 100-19 (1987); S. Rep. No. 91-1084 (1970); H.R. Rep. No. 84-609 (1955). Congress reaffirmed its desire to maintain the general separation of banking and commerce as recently as 1999, when it passed the GLBA. That act amended the Home Owners’ Loan Act (HOLA) to end the exception that allowed commercial firms to acquire a federally insured savings association. At the same time and after lengthy debate, Congress decided to allow FHCs to engage in only those activities determined to be financial in nature or incidental or complementary to financial activities. In fact, in passing the GLBA, Congress rejected earlier proposals that would have allowed FHCs to engage generally in a “basket” of commercial activities or that would have allowed commercial firms to acquire a small bank without becoming subject to the BHC Act. The GLBA did provide certain nonbanking firms that became a FHC after November 1999 up to 10 years to divest their impermissible commercial holdings if the firm was and remained “predominantly financial.” See 12 USC 1843(n). All commercial investments held under this authority were required to be divested no later than November 12, 2009.

<sup>10</sup> 12 USC 1843(a)(1) and (2).

contracted in good faith<sup>11</sup> or invest in a company that furnishes services to or performs services for the BHC or its banking subsidiaries.<sup>12</sup>

In addition, the BHC Act permits limited investments in companies that engage in nonbanking activities. Sections 4(c)(6) and 4(c)(7) permit BHCs to invest in any company, directly or indirectly through a wholly owned subsidiary, provided the investment does not exceed 5 percent of the outstanding voting shares, and up to 25 percent of the total equity, of the target company. The ownership limitation helps ensure that BHCs do not obtain control of nonfinancial companies in contravention of the policy of maintaining the separation of banking and commerce.

Under section 4(c)(8), a BHC may engage directly or indirectly in activities that the Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.<sup>13</sup> The authority of section 4(c)(8) represents the principal means by which a BHC may engage in activities other than those of banking or managing or controlling banks. A BHC must obtain the Board's approval prior to initiating activities pursuant to section 4(c)(8). The BHC Act requires the Board, in acting on a 4(c)(8) request, to consider whether the proposal "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the U.S. banking or financial system."<sup>14</sup> As part of its evaluation of these factors, the Board reviews the financial and managerial resources of the company involved, the effect of the proposal on competition in the relevant markets, the risk to the stability of the U.S. banking or financial system, and the public benefits of the proposal.<sup>15</sup>

The GLBA, enacted in 1999, amended the BHC Act to allow BHCs that qualify as FHCs to engage in an expanded range of permissible activities. Under the GLBA, a BHC may elect to be an FHC only if all of the depository institutions controlled by the BHC are well capitalized, well managed, and have at least a "satisfactory" rating at the most recent examination of the institution under the Community Reinvestment Act<sup>16</sup> (CRA).<sup>17</sup> The GLBA permits FHCs to

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<sup>11</sup> 12 USC 1843(c)(2).

<sup>12</sup> 12 USC 1843(c)(1). See appendix 1 for a complete list of the exceptions to the nonbanking prohibitions under section 4(c) of the BHC Act.

<sup>13</sup> Section 225.28(b) of the Board's Regulation Y lists permissible nonbanking activities that the Board has deemed to meet these criteria. 12 CFR 225.28(b). The Board also has permitted by order, on an individual basis, certain activities that it has considered to be closely related to banking under section 4(c)(8) of the BHC Act. In doing so, the Board did not expand the list of permissible activities under section 225.28(b) of Regulation Y. See appendix 2 for a complete list of the activities that have been determined to be closely related to banking under section 4(c)(8) of the BHC Act.

<sup>14</sup> See 12 USC 1843(j)(2)(A); 12 CFR 225.26.

<sup>15</sup> *Id.*

<sup>16</sup> 12 USC 2903 et seq.

engage in a broad range of activities that are defined by the GLBA to be financial in nature or incidental to a financial activity, or that the Board, in consultation with the Secretary of the Treasury, determines to be financial in nature or incidental to a financial activity.<sup>18</sup> The GLBA also allows an FHC to seek Board approval to engage in any activity that the Board determines both to be complementary to a financial activity and not to pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.<sup>19</sup> At the same time the GLBA expands permissible activities for FHCs, it limits activities permissible for other BHCs under section 4(c)(8) of the BHC Act to those that the Board had approved by order or regulation before the enactment of the GLBA.<sup>20</sup>

## Activities and Investments of State Member Banks

The Federal Reserve also is responsible for the supervision and regulation of state chartered commercial banks that choose to become members of the Federal Reserve System.<sup>21</sup> As a general matter, the activities of an insured state bank, including one that is a member of the Federal Reserve System, are governed by the laws of the state in which the bank is located and applicable federal law.

The Federal Reserve Act (FRA) provides that “any [state] bank becoming a member of the Federal Reserve System shall retain its full charter and statutory rights as a state bank ... and may continue to exercise all corporate powers granted it by the State in which it was created. ...”<sup>22</sup> However, the Federal Reserve “may limit the activities of State member banks and subsidiaries of State member banks in a manner consistent with section 24 of the Federal Deposit Insurance Act” (FDI Act).<sup>23</sup> Section 24 of the FDI Act generally provides that a state bank may not engage

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<sup>17</sup> 12 USC 1843(l)(1).

<sup>18</sup> 12 USC 1843(k).

<sup>19</sup> *Id.*

<sup>20</sup> 12 USC 1843(c)(8).

<sup>21</sup> A state-chartered bank proposing to become a member of the Federal Reserve System or a national bank converting to a state charter and desiring to remain a member of the Federal Reserve System must file an application for prior Federal Reserve approval. 12 CFR 208.3. A state member bank must receive the prior approval of the Board before making any significant change in the general character of its business. Changes in the general character of a bank’s business would include, for example, providing a significant level of credit facilities to a new customer base or in a new geographic area or concentrating solely on subprime lending or leasing activities. These activities can present novel risks for banking organizations, depending on how they are conducted and managed and also may present risks to the deposit insurance fund. In many cases, these activities involve aggressive growth plans and may give rise to significant financial, managerial, and other supervisory issues. A significant change in a bank’s business plan without the Board’s prior approval may be considered a violation of Regulation H and may be addressed through supervisory action. See 12 CFR 208.3(d)(1).

<sup>22</sup> 12 USC 330.

<sup>23</sup> *Id.*

as principal in any activity that is not permissible for national banks.<sup>24</sup> As a consequence, the activities of national banks outlined by the OCC generally represent the activities that state-chartered banks may engage in as principal.

State member banks may establish operations subsidiaries to engage in the same activities as, and subject to the same limitations as would be applied to, the parent bank.<sup>25</sup> The authority to operate through an operations subsidiary permits state member banks to exercise their incidental powers to organize their operations in the manner that they believe best facilitates the performance of their activities.

In addition, U.S. BHCs and banks generally may conduct a wider range of activities abroad than they may conduct in the United States. U.S. BHCs and banks may engage in international operations that are usual in connection with the conduct of banking abroad through a variety of means, including through the establishment of foreign branches; investments in Edge corporations, which are chartered and regulated by the Board;<sup>26</sup> or investments in so-called agreement corporations, which are similar to Edge corporations and are organized under state or federal law.<sup>27</sup> Edge and agreement corporations are international banking vehicles whose activities are governed by the Board's Regulation K and the FRA. Edge and agreement corporations may engage in international banking or financial activities (free of certain U.S. banking restrictions) and in activities in the United States that are incidental to their international or foreign business. These activities and their limitations, including with regard to scope and conduct, are listed in the Board's Regulation K.<sup>28</sup>

## Activities and Investments of FBOs Operating in the United States

FBOs have been operating in the United States for more than a century, but the U.S. branches and agencies of these organizations were not subject to supervision or regulation by any federal banking agency before 1978. In 1978, Congress enacted the IBA, which subjected U.S. branches and agencies of foreign banks to federal supervision. The IBA established a policy of "national treatment" for FBOs operating in the United States to promote competitive equality between

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<sup>24</sup> See 12 USC 1831a(a). State banks are permitted to engage in activities as principals that are not permitted for national banks if the FDIC determines that the activity would not pose significant risk to the Deposit Insurance Fund and the bank continues to comply with applicable capital standards set by the appropriate federal banking agency. The Federal Reserve may also limit the activities of state member banks in a manner consistent with section 24 of the FDI Act. See 12 USC 330.

<sup>25</sup> 12 CFR 250.141.

<sup>26</sup> 12 USC 611 et seq.

<sup>27</sup> Agreement corporations are called such because they must enter into an agreement with the Board providing that they will not exercise any power impermissible for an Edge corporation.

<sup>28</sup> See 12 USC 611 et seq.; 12 CFR 211.6 and 12 CFR 211.8.

FBOs and domestic institutions.<sup>29</sup> This policy generally gives FBOs operating in the United States the same powers as U.S. banking organizations and generally subjects FBOs to the same restrictions and obligations that apply to the domestic operations of U.S. banking organizations.<sup>30</sup> Under this regulatory structure, FBOs that own U.S. banks or that operate in the United States through a branch, agency, or commercial lending company subsidiary are treated as BHCs and are subject to the BHC Act.<sup>31</sup> As such, under the BHC Act and the IBA, the Federal Reserve is responsible for approving, reviewing, and monitoring the U.S. nonbanking activities of FBOs that have a branch, agency, commercial lending company, or subsidiary bank in the United States.

The U.S. activities and investments of FBOs generally are subject to the same limitations as domestic banking organizations under the policy of national treatment. U.S. law does permit FBOs that are or are treated as BHCs to engage in the same business activities in the United States that they conduct abroad, subject to the Board's prior approval. In authorizing these activities, the Board must consider whether the conduct of such activities is in the public interest and not substantially at variance with the BHC Act.<sup>32</sup>

## Activities and Investments of SLHCs

The statutory framework governing the activities and investments of SLHCs distinguishes between SLHCs that owned only one thrift (unitary SLHCs) and those that own more than one thrift (multiple SLHCs). Historically, multiple SLHCs were generally permitted to engage in financial activities but were limited in their commercial activities.<sup>33</sup> Unlike multiple SLHCs, unitary SLHCs were permitted to operate without activity restrictions.<sup>34</sup> In passing the GLBA, Congress sought to lessen the disparity between the permissible activities of unitary and multiple SLHCs. In particular, the GLBA subjected unitary and multiple SLHCs to the same activities restrictions, which generally limited these companies' activities to "financial activities."<sup>35</sup> The

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<sup>29</sup> Pub. L. No. 95-369, 92 Stat. 607.

<sup>30</sup> The Federal Reserve has responsibility to regularly examine the U.S. operations of foreign banks. Supervisory actions resulting from examinations may be taken by the Federal Reserve alone or with other agencies.

<sup>31</sup> See 12 USC 3106(a).

<sup>32</sup> 12 USC 1841(h) and 12 USC 1843(c)(9). To take advantage of this exception, a foreign entity that an FBO would use to engage in activities in the United States must derive most (more than half) of its revenues and assets from outside the United States, and the foreign entity may engage in the United States in only the same line of business it conducts outside the United States, i.e., its nonbanking and nonfinancial activities in the United States are the same as or related to its international business. Regulation K implements these two statutory provisions in a two-step process: first, Regulation K applies the nonbanking restrictions of section 4 of the BHC Act to any FBO, and second, Regulation K provides section 4(c)(9) and 2(h) exemptions to "qualifying foreign banking organizations."

<sup>33</sup> HOLA governs the activities of SLHCs. 12 USC 1467a(c).

<sup>34</sup> Pub. L. No. 73-43, 48 Stat. 128 (1933).

<sup>35</sup> Pub. L. No. 106-102, 113 Stat. 1434 (1999).



act included a provision that grandfathered those unitary SLHCs that were already in existence at the time of the act's passage (grandfathered unitary SLHCs or GUSLHCs), permitting them to continue to operate without activity restrictions. Dodd–Frank made important alterations to the statutory framework governing SLHCs, including by transferring from the OTS to the Board the responsibility for supervision of SLHCs and their nondepository subsidiaries and by subjecting SLHCs to the requirements applicable to FHCs.<sup>36</sup>

## **Activities and Investments Authorized for Banking Entities Regulated by the Federal Reserve Under the GLBA and Dodd–Frank**

### **Overview of FHC Status and Changes Made by the GLBA and Dodd–Frank**

As previously discussed, the GLBA significantly expanded the range of permissible activities of certain BHCs (including FBOs that are or are treated as BHCs) and SLHCs. In particular, the GLBA created the FHC status and authorized BHCs and FBOs that qualify and elect to become FHCs to engage in a broad range of financial activities directly or through affiliation with securities firms, insurance firms, and other financial companies.<sup>37</sup>

The GLBA includes conditions that must be met for a BHC or an FBO to qualify as an FHC. In particular, the GLBA requires that all depository institutions controlled by the BHC be well capitalized and well managed and have a CRA rating of “satisfactory” or better. In addition, section 606(a) of Dodd–Frank adds to these requirements that the holding company itself must be well managed and well capitalized.<sup>38</sup>

An FHC is permitted to engage in any activity that (i) the GLBA defines as financial in nature or incidental to a financial activity, or (ii) the Board, in consultation with the Secretary of the Treasury, determines to be financial in nature or incidental to a financial activity. The GLBA defined a list of activities as financial, including securities underwriting, dealing and brokerage activities, insurance underwriting and agency activities, merchant banking, and insurance company portfolio investment activities.<sup>39</sup> If a BHC qualifies as an FHC and provides notice to

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<sup>36</sup> Dodd–Frank also transferred supervisory functions related to federal savings associations and state savings associations to the OCC and the FDIC, respectively. In addition, the act provided for the use of an intermediate holding company (IHC) as a mechanism for segregating a GUSLHC's financial and nonfinancial activities. Dodd–Frank section 626, 124 Stat. 1638 (codified at 12 USC 1467b). The purpose of segregating a GUSLHC's financial activities from its nonfinancial activities is to ensure appropriate supervision and regulation of the former while also ensuring that such regulation does not extend to the latter. As the Board gains more experience with supervision of GUSLHCs, the Board will gain insight into the efficacy of the IHC provisions.

<sup>37</sup> The authority for FHCs to engage in these new activities is in section 4(k) of the BHC Act, 12 USC 1843(k).

<sup>38</sup> 12 USC 1843(l)(1). With regard to an FBO that operates a branch or agency or that owns or controls a commercial lending company in the United States, the GLBA requires the Board to apply comparable capital and management standards that give due regard to the principle of national treatment and equality of competitive opportunity.

<sup>39</sup> 12 USC 1843(k)(4).

the Board, the company may engage directly or indirectly in any of the financial activities authorized under the BHC Act, without having to seek prior approval of the Board.

The GLBA also allows an FHC to seek Board approval to engage in any activity that the Board determines (i) is complementary to a financial activity and (ii) does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.<sup>40</sup> BHCs and FBOs that do not qualify as FHCs are limited to engaging in those nonbanking activities that were permissible under section 4(c)(8) of the BHC Act before enactment of the GLBA, thus limiting the ability of BHCs and FBOs that are not FHCs to expand their activities.

The GLBA authorized banks, including state member banks and national banks, to engage in some of the financial activities authorized under section 4(k) of the BHC Act through financial subsidiaries.<sup>41</sup> Unlike operations subsidiaries, financial subsidiaries are permitted to engage in activities that are not permissible for their parent banks.<sup>42</sup> A financial subsidiary is permitted to engage in activities that have been determined to be financial in nature, although they are specifically prohibited from engaging in merchant banking and insurance underwriting.<sup>43</sup> In order to protect the safety and soundness of parent banks, the GLBA applies certain restrictions to financial subsidiaries that do not apply to operations subsidiaries, including restrictions on transactions between the bank and the financial subsidiary.<sup>44</sup>

As noted, the GLBA permits SLHCs to engage in financial activities permitted for FHCs under section 4(k) of the BHC Act. Prior to Dodd–Frank, the OTS interpreted this grant of authority as permitting SLHCs to engage in these financial activities without having to meet the CRA requirements and enhanced financial and managerial standards that BHCs are required to meet to engage in the same activities.<sup>45</sup> Dodd–Frank amended the HOLA to provide that SLHCs may engage in 4(k) financial activities only after they make an effective election to be treated as an

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<sup>40</sup> To implement the provisions of the GLBA that govern FHCs, the Board amended Regulation Y by adding subpart I for FHCs. With respect to permissible activities of FHCs, the regulation includes activities that previously were determined to be closely related to banking under section 225.28 of Regulation Y, activities that are usual in connection with transactions of banking abroad (including those in section 211.10 of Regulation K), and other activities defined as financial in nature by the GLBA. 12 CFR 225.81 et seq.

<sup>41</sup> Pub. L. No. 106-102, 113 Stat. 1338 (1999).

<sup>42</sup> Id. at section 121, 113 Stat. 1373 (codified at 12 USC 24a).

<sup>43</sup> Section 208.72 of the Board’s Regulation H provides a comprehensive list of the activities that financial subsidiaries of state members are permitted to engage in. 12 CFR 208.72.

<sup>44</sup> Financial subsidiaries are considered affiliates of the member bank under the Board’s Regulation W. 12 CFR 223.2. Accordingly, transactions between a bank and its financial subsidiaries are subject to the individual and aggregate quantitative limits and collateral requirements of sections 23A and 23B of the FRA.

<sup>45</sup> 12 USC 1467a(c)(9)(A)–(B). See also Federal Reserve System, “Authority for Certain Savings and Loan Holding Companies to Engage in Financial Activities,” 66 Fed. Reg. 56488 (November 8, 2001). Prior to the transfer date, in order to engage in 4(k) activities, SLHCs generally were not required to make any pre- or post-notice filings with the OTS. See id.

FHC.<sup>46</sup> In light of this change, the Board has imposed the same requirements on SLHCs seeking to engage in 4(k) financial activities as are required of BHCs seeking to engage in the same activities.<sup>47</sup>

## Discussion of Activities and Investments Authorized under the GLBA

As noted, the GLBA significantly altered the legal framework governing the permissible affiliations and activities of banking organizations in the United States by, among other things, permitting banks, securities firms, and insurance companies to affiliate with each other through the FHC structure. In addition to the financial and financially-related activities generally authorized for all FHCs, the GLBA also grandfathered the commodities activities of certain FHCs. The investments and activities authorized under the GLBA (collectively, covered investments and activities) and the framework for regulating and supervising them are discussed in detail further in this report.

Tables 1.1 and 1.2 on the following page provide information on the number of BHCs, the number of FHCs, and information on the total assets of BHCs and FHCs. Table 1.3 on the following page provides further details concerning the aggregate asset size of BHCs and FHCs.<sup>48</sup> The number of FHCs in comparison to the total number of BHCs and SLHCs reflects in large part the fact that few community banking organizations have chosen to conduct financial activities that require FHC status, and does not indicate that those banking organizations would fail to meet the qualifications to become an FHC.

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<sup>46</sup> 12 USC 1467a(c)(2).

<sup>47</sup> Federal Reserve System, “Availability of Information,” 76 Fed. Reg. 56508, 56510 (September 13, 2011).

<sup>48</sup> The information provided in this section of the report differentiates between those BHCs and FHCs whose ultimate parent (top tier or top holder) is or is not incorporated domestically in the United States. Those with ultimate parents that are not located in the United States are designated as foreign BHCs or FHCs. To avoid double counting, only the top tier BHC in a multi-tier organization is included in the data.

**Table 1.1: Aggregate Number of BHCs, SLHCs, and FHCs**

	<b>12/31/2012</b>	<b>12/31/2013</b>	<b>12/31/2014</b>	<b>12/31/2015</b>
Number of domestic BHCs	4,573	4,479	4,361	4,213
Number of foreign BHCs	30	30	28	27
Total number of BHCs	4,603	4,509	4,389	4,240
Total number of SLHCs	368	334	296	260
Number of domestic BHCs that are also FHCs	410	419	426	440
Number of foreign BHCs that are also FHCs	13	13	13	14
Total number of BHCs that are also FHCs	423	432	439	454
Total number of SLHCs that are also FHCs	6	7	9	8
Percentage of BHCs that are also FHCs	9%	10%	10%	11%
Percentage of SLHCs that are also FHCs	2%	2%	3%	3%

**Table 1.2: Aggregate Assets of BHCs and FHCs (Billions)**

	<b>12/31/2012</b>	<b>12/31/2013</b>	<b>12/31/2014</b>	<b>12/31/2015</b>
Assets of domestic BHCs	\$14,638	\$14,817	\$15,440	\$15,707
Assets of foreign BHCs	\$2,082	\$2,112	\$2,163	\$2,308
Total assets of BHCs	\$16,720	\$16,929	\$17,603	\$18,015
Total assets of SLHCs	\$2,890	\$2,665	\$2,596	\$2,426
Assets of domestic BHCs that are also FHCs	\$12,537	\$12,903	\$13,439	\$13,514
Assets of foreign BHCs that are also FHCs	\$1,871	\$1,907	\$1,897	\$2,029
Total assets of BHCs that are also FHCs	\$14,408	\$14,810	\$15,336	\$15,543
Total assets of SLHCs that are also FHCs	\$52	\$58	\$61	\$58
Total assets of BHCs that are also FHCs as a % of BHC total assets	86%	87%	87%	86%
Total assets of SLHCs that are also FHCs as a % of SLHC total assets	2%	2%	2%	2%

**Table 1.3: Number of U.S.-based FHCs by Asset Size as of 12/31/2015**

Asset size	BHCs that are FHCs	Total number of BHCs	SLHCs that are FHCs	Total number of SLHCs
Over \$250 billion	12	12	0	4
\$50 billion to \$250 billion	21	25	0	4
\$10 billion to \$50 billion	32	52	2	13
\$1 billion to \$10 billion	132	458	2	47
\$150 million to \$1 billion	220	2138	4	126
Less than \$150 million	37	1555	0	66

### *Securities Underwriting and Dealing*

Before the adoption of the GLBA, BHCs were permitted to engage to a limited extent through a so-called section 20 subsidiary in underwriting and dealing in securities that a member bank may not underwrite or deal in directly (bank-ineligible securities). Such a subsidiary was called a section 20 subsidiary in reference to section 20 of the Glass–Steagall Act, which limited affiliations between certain securities companies and banks.<sup>49</sup> A section 20 subsidiary was limited to deriving no more than 25 percent of its gross revenue from underwriting or dealing in bank-ineligible securities.<sup>50</sup>

The GLBA created a “two-way street” between securities firms and banking organizations, significantly expanding the ability of BHCs to engage in securities underwriting and dealing (including acquiring a full-service securities firm) and, as a result, the ability of securities firms to affiliate with banks through the FHC structure. Specifically, the GLBA repealed section 20 of the Glass–Steagall Act and expressly permitted FHCs to underwrite and deal in all types of securities, including corporate debt and equity securities, without limit as to the amount of revenue the subsidiary may derive from underwriting and dealing in bank-ineligible securities.<sup>51</sup> Additionally, an FHC’s broker-dealer subsidiaries are allowed to engage in dealing activities

<sup>49</sup> Section 20 of the Glass–Steagall Act prohibits banks from being affiliated with any organization that is “engaged principally” in securities underwriting or dealing in bank ineligible securities. However, the statute does not define “engaged principally.” The Board has interpreted section 20 to permit BHCs to own subsidiaries that engage in underwriting and dealing in bank-ineligible securities as long as the revenue generated from the subsidiaries’ ineligible securities activities amounts to no more than 25 percent of the total revenues they generate.

<sup>50</sup> A section 20 subsidiary also may be limited, by the terms of the Board’s approval order, in the types of securities that it may underwrite or deal in. Moreover, no section 20 subsidiary may underwrite or deal in shares of an open-end investment company or mutual fund.

<sup>51</sup> See 12 USC 1843(k)(4)(E); GLBA section 101, Pub. L. No. 106-102, 113 Stat. 1341 (1999).

without having to comply with the 5 percent ownership restriction that applies to section 20 subsidiaries. Without these restrictions, FHCs are able to structure their securities operations more efficiently and to compete more effectively with securities firms that are not affiliated with banks.

Table 1.4 provides information on the number of FHCs that have subsidiaries that engage in securities underwriting and dealing activities.

**Table 1.4: Securities Underwriting and Dealing Activities of FHCs**

<b>Number of FHCs engaged in securities underwriting</b>	<b>12/31/2012</b>	<b>12/31/2013</b>	<b>12/31/2014</b>	<b>12/31/2015</b>
Domestic FHCs	36	33	32	30
Foreign FHCs	22	22	22	19
Total	58	55	54	49

### *Insurance Underwriting and Agency Activities*

Before the GLBA, insurance underwriting and agency activities of BHCs in the United States were limited by the Garn–St Germain Depository Institution Act of 1982 (Garn–St Germain Act), which generally prohibited BHCs from underwriting or selling any type of insurance.<sup>52</sup> There were certain exceptions to this general prohibition, the most important of which permitted BHCs to (i) underwrite and sell certain types of credit-related insurance and (ii) to sell any type of insurance as agent in places that have a population of 5,000 or less. Under the GLBA, FHCs are permitted to underwrite or sell any type of insurance underwriting or agency activities without geographic limit.<sup>53</sup> The GLBA permits an FHC to acquire any type of insurance company or insurance agency, and it permits insurance companies and insurance agencies to acquire or affiliate with a bank through the FHC structure. Moreover, an insurance underwriting subsidiary of an FHC is allowed to invest the company’s assets in accordance with state law governing such investments.<sup>54</sup> As a result of the GLBA and marketplace developments, many banking entities have increased the range and volume of their insurance and annuities sales activities.<sup>55</sup>

<sup>52</sup> Pub. L. No. 97-320, 96 Stat. 1469 (1982). The GLBA also expanded the ability of banks to sell any type of insurance nationwide through a financial subsidiary of the bank. It should also be noted that many BHCs, before and after enactment of the GLBA, have conducted insurance sales through a subsidiary bank of the holding company under other legal authorities. For many years, state-chartered banks have generally been able to sell insurance as agent, either directly or through a subsidiary, to the extent permitted by the law of the bank’s chartering state.

<sup>53</sup> See 12 USC 1843(k)(4)(B).

<sup>54</sup> See 12 USC 1843(k)(4)(I). However, an FHC and its insurance company subsidiary are prohibited from routinely managing or operating any company acquired under such authority except as may be necessary or required to obtain a reasonable return on the investment.

<sup>55</sup> To the extent permitted by applicable law, banking entities may conduct insurance and annuity sales activities through a variety of structures and delivery channels, including ownership of an insurance underwriter or an

Table 1.5 provides information on the number of FHCs that engage in insurance underwriting activities.

**Table 1.5: Number of Financial Holding Companies Engaged in Insurance Underwriting Activities**

<b>FHCs engaged in GLBA insurance underwriting activities</b>	<b>12/31/2012</b>	<b>12/31/2013</b>	<b>12/31/2014</b>	<b>12/31/2015</b>
Domestic FHCs	36	39	39	37
Foreign FHCs	2	3	1	1
Total	38	42	40	38
Reported insurance underwriting assets (billions)	\$86.7	\$65.8	\$64.5	\$59.4

### *Merchant Banking*

The GLBA permits FHCs to make a broader range of investments in commercial companies. The merchant banking provision of the GLBA<sup>56</sup> permits an FHC to make investments, as part of a bona fide underwriting, merchant banking, or investment banking activity, in any type of ownership interest (including voting and nonvoting interest) of any nonfinancial company (including corporations, partnerships, limited liability companies and other entities) engaged in an activity not otherwise authorized for an FHC under section 4 of the BHC Act. These investments may be in any amount, including up to all of the ownership interest, of a company (portfolio company), and may be made by the FHC directly or through any subsidiary (other than through a depository institution or subsidiary of such institution). To ensure that the merchant banking authority is used to make only bona fide financial investments, as well as to further the fundamental purposes of the BHC Act of maintaining the separation of banking and commerce and promoting safety and soundness, the GLBA permits such investments to be held for a period of time to enable the sale or disposition on a reasonable basis and generally prohibits an FHC from routinely managing or operating a nonfinancial company held as a merchant banking investment. In 2001, the Board, jointly with the Secretary of the Treasury, issued regulations implementing the merchant banking provision of the GLBA and the associated restrictions on holding periods and routine management.<sup>57</sup>

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insurance agency or broker, the employment by a bank of licensed agents, a joint marketing arrangement with a producer, independent agents located at a bank's office, direct mail, telemarketing, and Internet marketing.

<sup>56</sup> 12 USC 1843(k)(4)(H).

<sup>57</sup> Federal Reserve System, "Bank Holding Companies and Change in Bank Control," 66 Fed. Reg. 8466 (January 31, 2001) (codified at 12 CFR 225.170 et seq.). The regulation allows FHCs to hold merchant banking investments for up to 15 years.

Table 1.6 provides information on the number of FHCs that engage in merchant banking activities.

**Table 1.6: Number of FHCs Engaged in Merchant Banking Investment Activities**

<b>FHCs holding merchant banking assets under GLBA</b>	<b>12/31/2012</b>	<b>12/31/2013</b>	<b>12/31/2014</b>	<b>12/31/2015</b>
Domestic FHCs	17	17	16	16
Foreign FHCs	5	5	5	5
Total	22	22	21	21
Reported carrying value of merchant banking investments (billions)	\$49.30	\$43.40	\$31.98	\$26.78

### *Complementary Activities*

In addition to permitting FHCs to engage in financial activities, the GLBA permits an FHC to seek, on a case-by-case basis, prior approval to engage in any activity that the Board determines (i) is complementary to a financial activity and (ii) does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.<sup>58</sup> Complementary authority allows FHCs to engage, on a limited basis, in activities that, although not financial in nature, are so meaningfully connected to financial activities that they complement the financial activities. In this way, FHCs would not be disadvantaged by market developments if commercial activities evolved into financial activities or competitors found innovative ways to combine financial and nonfinancial activities.

Since passage of the GLBA, the Board has approved a number of activities as complementary activities. These activities include disease management and mail order pharmacy activities,<sup>59</sup> as well as activities related to physical commodities,<sup>60</sup> such as trading in energy-related

<sup>58</sup> 12 USC 1843(k)(1)(B); 12 CFR 225.28(b)(8)(ii). The BHC Act provides the Board with exclusive authority to determine that an activity is complementary to a financial activity. Factors that the Board must consider under the BHC Act when acting on a complementary activity request include safety and soundness of the activity and possible adverse effects, such as decreased or unfair competition.

<sup>59</sup> See “Order Determining that Certain Activities are Complementary to the Financial Activity of Underwriting and Selling Health Insurance,” 93 Fed. Res. Bull. C133 (2007).

<sup>60</sup> The Board authorizes firms to conduct complementary physical commodities activities on a case-by-case basis. In all, the Board has authorized a dozen firms to engage in complementary physical commodities activities, including Bank of America Corporation, Barclays Bank PLC, BNP Paribas, Citigroup Inc., Credit Suisse, Deutsche Bank AG, JP Morgan Chase & Co., Scotiabank, Société Générale, the Royal Bank of Scotland Group PLC, UBS AG, and Wells Fargo & Company. The Board’s approvals regarding section 4(k) are publicly available. See, e.g., Board



commodities and energy tolling and management services.<sup>61</sup> Physical commodity trading activities involve purchasing and selling physical commodities (such as oil, natural gas, agricultural products, and other nonfinancial commodities) in the spot market and taking and making delivery of such commodities in connection with engaging as principal in commodity derivatives. Energy tolling entails making periodic fixed payments to the owner of a power generation facility in exchange for the right to all or part of the plant's power output; it also includes supplying fuel and making payments to cover the owner's variable costs plus a profit margin. Energy management services consist primarily of acting as a financial intermediary (providing transactional and advisory services) to power plant owners by substituting the FHC's credit and liquidity for those of the power plant owner to facilitate the owner's purchase of fuel and sale of power. Disease management and mail-order pharmacy activities involve the provision of services that help employers that obtain health insurance from an insurance company to manage and reduce the risks and costs of providing health insurance to employees. As discussed in greater detail below, in each order approving an activity as a complementary activity, the Board has imposed important restrictions to limit the size and scope of these activities to address the risks associated with the conduct of each activity.

#### *Section 4(o) Commodities Activities*

The GLBA also amended the BHC Act to permit FHCs that meet the criteria in section 4(o) to engage in a potentially broader set of physical commodity activities than generally authorized for BHCs and other FHCs.<sup>62</sup> Specifically, section 4(o) may permit a qualifying FHC to own, operate, or invest in facilities for the extraction, transportation, storage, or distribution of commodities, or to process or refine commodities. This authority potentially allows certain FHCs to engage in physical commodities activities that are broader than authorized for BHCs and FHCs, including under merchant banking and complementary authority, as discussed previously. Under section 4(o), a company that was not a BHC and becomes an FHC after November 12, 1999, may continue to engage in activities related to the trading, sale, or investment in commodities and underlying physical properties that were not permissible for BHCs as of September 30, 1997, if the company was engaged in the United States in any of such activities as of September 30, 1997. To date, only two FHCs—Goldman Sachs and Morgan Stanley—have qualified to engage in physical commodities activities under section 4(o).

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letters dated September 29, 2006, regarding Fortis S.A./N.V., and April 13, 2006, regarding Wachovia Corporation; Société Générale, 92 Fed. Res. Bull. C1 13 (2006); Deutsche Bank AG, 92 Fed. Res. Bull. C54 (2006); JP Morgan Chase & Co., 92 Fed. Res. Bull. C57 (2006); Barclays Bank PLC, 90 Fed. Res. Bull. 511 (2004); UBS AG, 90 Fed. Res. Bull. 215 (2004); and Citigroup Inc., 89 Fed. Res. Bull. 508 (2003).

<sup>61</sup> See Fortis S.A./N.V., 94 Fed. Res. Bull. C20 (2008); The Royal Bank of Scotland Group PLC, 94 Fed. Res. Bull. C60 (2008).

<sup>62</sup> 12 USC 1843(o). This statutory provision limits these grandfathered activities to no more than 5 percent of the FHC's total consolidated assets and prohibits the FHC from cross-marketing the services of its subsidiary depository institution(s) and its subsidiary(ies) engaged in activities authorized under section 4(o).

## Risk Mitigation and Legal Limitations Relating to Covered Investments and Activities

### General Limitations—FHC Status, Capital, and Other Initiatives to Ensure Safety and Soundness

#### *FHC Status*

The potential risks associated with covered investments and activities are addressed by statutory, regulatory, and supervisory limitations. To begin with, the GLBA authorizes covered activities and investments only for BHCs that qualify as FHCs. As discussed previously, to qualify as an FHC, BHCs and SLHCs must meet the following criteria: (i) all of the holding company’s depository institution subsidiaries must be well capitalized and well managed, (ii) all of the holding company’s insured depository institution subsidiaries must have at least a “satisfactory” rating under the CRA,<sup>63</sup> and (iii) pursuant to Dodd–Frank, the holding company itself must be well capitalized and well managed.<sup>64</sup> By ensuring that only holding companies that meet higher standards for capital and management may engage in these activities, the GLBA and Dodd–Frank mitigate the potential harm that can flow from risks associated with covered investments and activities. Companies that cease to meet the applicable capital and management standards must act to restore their capital and management to FHC standards and must obtain the Board’s prior approval before engaging in new covered investments and activities.<sup>65</sup>

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<sup>63</sup> 12 USC 2901 et seq. The Board has established comparable capital and managerial requirements for foreign banks that are subject to the BHC Act because they maintain a branch or agency in the United States or control a commercial lending company in the United States, all pursuant to the GLBA. See 12 USC 1843(l)(3); 12 CFR 225.81 and 12 CFR 225.90.

<sup>64</sup> Dodd–Frank section 606, 124 Stat. 1607 (codified at 12 USC 1843(l)(1) and 1467a(c)(2)). This change became effective on July 21, 2011. The Board’s Regulations Y and LL outline the process under which BHCs and SLHCs may elect to be treated as FHCs. See 12 CFR 238.61 et seq. and 12 CFR 225.81 et seq.

<sup>65</sup> Under the Board’s existing rules concerning FHCs, a company that ceases to be both well capitalized and well managed must execute an agreement with the Board to comply with the applicable capital and management requirements (a corrective action agreement). This corrective action agreement must be executed within 45 days of the company’s receipt of the notice of deficiency (or such additional time the Board may allow if a company requests an extension of time), must explain the actions the company will take to correct all areas of noncompliance and the timeframe within which each action will be taken, must provide any other information the Board may require, and must be acceptable to the Board. If a company subject to a corrective action agreement does not correct the capital and/or management deficiencies within 180 days of receiving notice of a deficiency from the Board (or such other time as the Board may permit), the Board may order the company to divest ownership or control of any depository institution the company owns or controls. The company may comply with a divestiture order by ceasing to engage in any activity that may be conducted only under sections 4(k), (n), or (o) of the BHC Act. See 12 CFR 225.83 and 12 CFR 225.93.

## *Revised Capital Framework*

Additionally, the agencies have implemented changes to their respective risk-based capital standards<sup>66</sup> to require banking entities to increase the quality and quantity of capital held in order to offset the risks associated with the entities' activities and investments.<sup>67</sup> Specifically, the revised capital framework establishes a new definition of capital with new criteria and categories for capital components, as well as new regulatory capital standards and minimum levels for each component of regulatory capital.<sup>68</sup> In addition, large, internationally active banking organizations are required to maintain higher levels of capital for exposures to large and unregulated financial institutions and are required to meet a new minimum supplementary leverage ratio that takes into account off-balance-sheet exposures. The framework also includes higher counterparty credit risk capital requirements for over-the-counter derivatives and introduces a countercyclical capital buffer that allows regulators to require certain banking entities to hold a larger capital buffer during periods of increased systemic risk. Other important enhancements include (i) revisions to the methodologies for determining risk-weighted assets, such as for securitization exposures, past-due loans, and counterparty credit risk; (ii) modifications of the recognition of credit risk mitigation to include greater recognition of financial collateral and a wider range of eligible guarantors; and (iii) elimination of references to, and reliance on, credit ratings in the calculation of risk-weighted assets, consistent with the requirements of Dodd–Frank.

These reforms raise the quality, consistency, and transparency of the capital base, enhance the risk coverage of the capital framework, target improvements in risk management and governance, and strengthen banking entities' transparency and disclosures. Further, these reforms will improve the risk sensitivity of the risk-based capital framework for banking entities and will better incentivize appropriate risk-taking and risk-management by management and shareholders of banking entities.<sup>69</sup>

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<sup>66</sup> These changes are aimed towards strengthening the regulatory capital regime governing banking entities, especially large, complex, internationally active banks, and implementing international reforms. The OCC and the Board adopted final rules concerning the risk-based capital guidelines and capital adequacy guidelines in 2013. See “Regulatory Capital Rules,” 78 Fed. Reg. 62018 (October 11, 2013) (codified at 12 CFR 3, 5, 6, 165, 167, 208, 217, and 225).

<sup>67</sup> FHCs have long been required to hold capital against the counterparty credit risk from commodity derivatives (and other types of over-the-counter derivatives) and against the market risk of all commodity positions.

<sup>68</sup> Essentially, these enhancements will require that capital instruments meet a more stringent set of criteria that emphasize high quality capital by ensuring subordination, perpetuity, loss absorption, and other desirable characteristics present in all tier 1 capital instruments. For instance, the definition of “capital” has been revised to require that tier 1 common equity be the predominant form of tier 1 capital, and the capital element will be subject to revised minimum capital ratios: common equity tier 1, tier 1 capital, and total capital must be at least 4.5 percent, 6 percent, and 8 percent of risk-weighted assets at all times, respectively. These changes recognize that common equity and retained earnings possess superior loss absorption characteristics and comprise the highest quality form of capital. High amounts of loss-absorbing capital allow banking organizations to remain viable and continue lending to creditworthy borrowers in times of financial stress.

<sup>69</sup> These reforms were implemented in response to the last financial crisis, which exposed significant weaknesses in the regulatory capital requirements applicable to banking entities, especially large, complex ones. During the crisis, it became evident that the amount of capital held by many large, complex banking companies was inadequate to

## *Regulatory and supervisory initiatives to enhance safety and soundness*

The Board has also completed a number of key regulatory initiatives that are designed to strengthen the traditional framework for supervising and regulating major banking entities and addressing risks associated with their investments and activities. For example, the Board has established a number of enhanced prudential standards for large U.S. BHCs and FBOs under section 165 of Dodd–Frank to help increase the resiliency of these firms’ operations.<sup>70</sup> Among other things, the Board’s enhanced prudential standards require a U.S. BHC with assets of \$50 billion or more to comply with enhanced risk-management and liquidity risk-management standards, conduct liquidity stress tests, and hold a buffer of highly liquid assets based on projected funding needs during a 30-day stress event. In addition, publicly traded U.S. BHCs with total consolidated assets of \$10 billion or more are required to establish enterprise-wide risk committees. The enhanced standards also require FBOs with a significant U.S. presence to designate an intermediate holding company (IHC) and transfer ownership of all U.S. subsidiaries to the IHC in order to facilitate consistent supervision and regulation of the U.S. operations.

In addition, the Board, together with the other federal banking agencies, established a quantitative minimum liquidity coverage ratio (LCR rule) for large and internationally active banking organizations.<sup>71</sup> The LCR would also apply to nonbank financial companies designated by FSOC for Board supervision to which the Board has applied the LCR rule by separate rule or order. The Board has also established a modified LCR requirement for certain smaller, less complex banking organizations.<sup>72</sup> The LCR rule requires a company to maintain an amount of high-quality liquid assets (the numerator of the ratio) that is no less than 100 percent of its total net cash outflows over a prospective 30 calendar-day period of significant stress (the denominator of the ratio). The requirement is designed to promote the short-term resilience of the liquidity risk profile of large and internationally active banking organizations, thereby improving the banking sector’s ability to absorb shocks arising from financial and economic stress, and to further improve the measurement and management of liquidity risk. Other initiatives the Board has taken to improve the resiliency of Board-regulated institutions include

- implementing a risk-based capital surcharge for firms identified as global systemically important BHCs, or global systemically important banks (GSIBs).<sup>73</sup>

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cover the risks that had accumulated in the companies. For certain exposure types, such as trading positions, over-the-counter derivatives, and securitization and re-securitization exposures, it became evident that capital requirements did not adequately cover the risk of loss from those activities. In addition, it became apparent that some of the instruments that qualified as tier 1 capital for banking companies, the core measure of capital adequacy, were not truly loss absorbing.

<sup>70</sup> See 12 CFR 252. These standards include liquidity, risk management, and capital, as well as capital planning and stress testing requirements.

<sup>71</sup> See 12 CFR 249.

<sup>72</sup> See 12 CFR 249.

<sup>73</sup> “Regulatory Capital Rules,” 80 Fed. Reg. 49082 (August 14, 2015) (codified at 12 CFR 208 and 217).

- issuing a proposal to require the largest, most complex banking firms to maintain a minimum amount of loss absorbing instruments, including a minimum amount of long-term, unsecured debt, at the holding company level.<sup>74</sup>
- establishing minimum margin requirements for swaps and security-based swaps that are not cleared through a clearinghouse.<sup>75</sup>
- developing a proposed net stable funding ratio (NSFR), which will require firms to have a stable funding structure over a one-year horizon.<sup>76</sup>

The Board has also taken steps to strengthen the supervision and regulation of the largest, most complex banking organizations. With respect to supervision, the Board has established the Large Institution Supervision Coordinating Committee (LISCC)—composed of senior bank supervisors from the Board and relevant Reserve Banks as well as senior staff from research, legal, and other divisions at the Board and from the markets and payments systems groups at the Federal Reserve Bank of New York—to ensure that oversight and supervision of the largest firms incorporates a broader range of internal perspectives and expertise. The LISCC engages in regular, simultaneous, horizontal (cross-firm) supervisory exercises, provides a centralized process to facilitate consistent supervision, offers a consistent response to risks or problems that may be present in more than one firm, and adds a perspective on the financial system as a whole. To date, the LISCC has developed and administered several horizontal supervisory exercises, notably the capital stress tests and related comprehensive capital review of the nation’s largest BHCs.

FHCs engaging in physical commodities activities are typically among those supervised by LISCC.<sup>77</sup> That supervisory oversight, for example, can include review of the management of risks of those activities to the FHCs and assess the adequacy of the firms’ controls relating to physical commodities activities. The Board has conducted targeted reviews of the firms engaged in physical commodities activities, including through horizontal examinations of firms that are engaged in commodities activities by staff specializing in physical commodities activities.<sup>78</sup>

<sup>74</sup> “Total Loss-Absorbing Capacity,” 80 Fed. Reg. 74926 (November 30, 2015).

<sup>75</sup> “Margin and Capital Requirements for Covered Swap Entities,” 80 Fed. Reg. 74840 (November 30, 2015).

<sup>76</sup> This approach is intended to limit destabilizing funding runs and credit contraction, while not creating incentives for firms to hoard liquidity in periods of stress. The NSFR complements the liquidity coverage ratio, which was adopted by the Federal Reserve and other banking agencies in September 2014.

<sup>77</sup> The Federal Reserve’s supervisory program focuses on the enterprise-wide risk profile and risk management of regulated institutions, with particular emphasis on financial strength, corporate governance, and risk-management practices and competencies of the institutions as a whole. To this end, the Board monitors large, complex institutions on a continuous basis and routinely conducts inspections and examinations of these institutions to encourage their safe and sound operations. The Board’s supervision of these banking entities is done in cooperation with the functional regulators responsible for supervising some of the institutions’ principal business activities.

<sup>78</sup> The Board has also issued a new framework for consolidated supervision of large banking entities that strengthens traditional micro-prudential supervision and regulation to enhance the safety and soundness of individual firms, and incorporates macro-prudential considerations to reduce potential threats to the stability of the financial system. For more information about this supervisory framework, see SR Letter No. 12-17 / CA Letter No. 12-14, [“Consolidated Supervision Framework for Large Financial Institutions”](#) (December 17, 2012).

During these reviews, the teams examined exposures, valuations, and the ways firms monitored and managed risks from commodities activities. In addition, the teams reviewed the firms' processes for assessing capital needs associated with commodities investments and activities. On an ongoing basis, supervision of these activities includes monitoring the firms' exposures and assessing the strength of the corresponding risk-management and control processes.

## **Specific Limitations Related to Covered Investments and Activities**

The risks associated with a banking entity's conduct of covered investments and activities are also addressed by the limitations contained in the regulatory and supervisory framework that governs the particular activities. For example, as noted previously, the Board and the Secretary of the Treasury have issued regulations that provide limits for the conduct of merchant banking activities, and, in conjunction with its orders authorizing individual firms to engage in complementary activities, the Board has provided limitations associated with the conduct of complementary activities.

### *Securities and Insurance Activities*

As noted previously, the GLBA authorizes FHCs to engage in a broader range of financial activities, including conducting securities underwriting and dealing and serving as an insurance agent and underwriter. These activities, however, must be conducted in accordance with applicable restrictions and limitations found in the BHC Act and regulations or supervisory guidance adopted by the Board. For example, the Board's regulations impose restrictions on FHCs' securities underwriting, dealing, or market-making activities.<sup>79</sup> First, all intraday extensions of credit by a bank, thrift, or U.S. branch or agency of a foreign bank to an affiliated company engaged in these securities activities must be on market terms consistent with section 23B of the FRA. Additionally, a foreign bank that is an FHC must ensure that its U.S. branch or agency making a loan to, or purchasing securities as a principal or fiduciary from, such an affiliated company complies with sections 23A and 23B of the FRA as if the branch or agency were a member bank.<sup>80</sup>

In general, the primary risks associated with insurance sales activities, including operational, legal, and reputational risks, are the types of risks that the financial regulatory/supervisory framework is designed to address. If not adequately managed, these risks could have an adverse impact on the FHC earnings and capital; however, if adequately managed, these risks do not present significant safety and soundness concerns. In supervising covered securities and insurance investments and activities, as with other financial activities, the Federal Reserve evaluates the consolidated risk profile of FHCs and determines the risks posed to these companies from their investments and activities as well as the effectiveness of their own risk management systems. The scope of the Federal Reserve's review of insurance activities

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<sup>79</sup> See 12 CFR 225.4(g).

<sup>80</sup> The operating standards and revenue limit continue that apply to BHCs that are not FHCs and to FHCs that continue to conduct securities activities pursuant to section 4(c)(8) of the BHC Act.

increases based on the extent and type of the FHC's involvement in such activities, consistent with the Federal Reserve's risk-focused framework for supervising banking entities.

Dodd–Frank also made important changes to bolster the Board's ability to more effectively address the risks associated with these activities. For example, section 604 of Dodd–Frank reduced the limitations imposed by the GLBA with respect to the Federal Reserve's ability to examine, obtain reports from, or take enforcement actions against functionally regulated subsidiaries of a BHC, including one that qualifies as an FHC, and largely restores the authority held by the Federal Reserve prior to the passage of the GLBA vis-à-vis the insurance and broker-dealer subsidiaries of a BHC or an FHC.

### *Merchant Banking Activities*

Merchant banking investment activities pose a number of financial risks to FHCs, including market, credit, and other risks. In addition, commercial activities conducted by portfolio companies held by FHCs under merchant banking authority may cause, or may be affected by, catastrophic and environmental events that, in turn, could pose substantial legal and environmental risks. Moreover, the risks to an FHC and its depository institution subsidiaries posed by merchant banking investments increase when an FHC has not established appropriate risk management policies, procedures, and controls (including capital reserves).

To ensure the safe and sound conduct of merchant banking investment activities, subpart J of the Board's Regulation Y establishes a number of limitations,<sup>81</sup> including restrictions on the holding period for the investment, routine management or operations of the underlying portfolio company, cross-marketing, and affiliate transactions.<sup>82</sup> Moreover, Regulation Y requires an FHC that makes merchant banking investments to establish and maintain policies, procedures, records,<sup>83</sup> and systems reasonably designed to conduct, monitor, and manage investment activities and the associated risks in a safe and sound manner.<sup>84</sup> In particular, these policies, procedures, records, and systems must be reasonably designed to

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<sup>81</sup> The merchant banking provisions of Regulation Y were implemented jointly with the U.S. Department of the Treasury, as provided by the GLBA.

<sup>82</sup> 12 CFR 225.170 et seq.

<sup>83</sup> FHCs are generally able to comply with the record-keeping requirements by using internal reports and records that are prepared in the ordinary course of making a merchant banking investment. The regulations governing FHCs' merchant banking activities do not require an FHC to maintain the records described previously in a central location; rather, an FHC must be able to identify and promptly make the records—wherever located—available to the Federal Reserve upon request.

<sup>84</sup> If the FHC controls a private equity fund or other fund that makes merchant banking investments, the FHC must ensure that the fund has the types of policies, procedures, and systems described above for making and monitoring the fund's merchant banking investment activities. Alternatively, the FHC may ensure that the controlled fund is subject to the FHC's merchant banking policies, procedures, and systems.

- monitor and assess the carrying value, market value, and performance of each merchant banking investment and the company’s aggregate merchant banking investment portfolio.
- identify and manage the market, credit, and other risks associated with merchant banking investments.
- identify, monitor, and assess the terms, amounts, and risks arising from transactions and relationships (including contingent fees or contingent interests) with each portfolio company.
- ensure the maintenance of corporate separateness between the FHC and each portfolio company and protect the FHC and its depository institution subsidiaries from legal liability for the operations and financial obligations of any such company.
- ensure compliance with Regulation Y, including the holding period, routine management and operation, cross-marketing restrictions, and any other applicable provisions of law governing transactions and relationships with portfolio companies, such as in sections 23A and 23B of the FRA.

The Board has supplemented the limitations contained in Regulation Y with supervisory guidance that identifies other risk-mitigating features that an FHC should have in place to conduct merchant banking investment activities in a safe and sound manner.<sup>85</sup> Among other things, the Board’s guidance provides that an FHC engaged in merchant banking investments and activities should establish appropriate policies, procedures, and systems to manage all elements of the investment decision-making and risk management process.<sup>86</sup> The supervisory guidance also provides that an FHC should monitor its lending and other business relationships with a portfolio company to ensure that the FHC’s aggregate exposure to the portfolio company is reasonably limited and that all transactions are on reasonable terms. An FHC should also maintain records that appropriately document these policies, procedures, and systems and make such records available to examiners to ensure the existence of, and the company’s compliance with, such policies, procedures, and systems.

As discussed above, most firms engaged in merchant banking activities are subject to continuous monitoring because of the size and complexity of these organizations. The Board also believes that appropriate capital levels and strong risk management policies and practices help address financial risks from merchant banking activities, including market and credit risks. Thus, for example, while the Board permits an FHC to hold any merchant banking investment for a period of up to 10 years (and permits the period to be extended with specific prior approval), the

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<sup>85</sup> See Federal Reserve, SR Letter No. 00-09, “Supervisory Guidance on Equity Investment and Merchant Banking Activities” (June 22, 2000). The supervisory guidance applies to FHCs engaged in making merchant banking investments under section 4(k)(4)(H) of the BHC Act, as well as BHCs that make equity investments in nonfinancial companies through small business investment companies or under sections 4(c)(6) or (7) of the BHC Act. The supervisory guidance describes in detail the internal controls and risk management policies, procedures, and systems that the Federal Reserve expects BHCs engaged in equity investment activities to have and maintain to conduct equity investment activities in a safe and sound manner.

<sup>86</sup> These policies, procedures, and systems include limits on the types and amounts of merchant banking investments that may be made; parameters governing portfolio diversification; sound policies governing the valuation and accounting of investments; periodic audits of compliance with established limits and policies; and policies designed to ensure that all investments in, and relationships with, portfolio companies comply with applicable law.



Board's regulations apply a special capital charge to merchant banking investments that are held beyond the initial period.<sup>87</sup> The capital charge is set at a rate that is above the highest marginal tier 1 capital charge applicable under the Board's capital guidelines for merchant banking investments held by that FHC, but the rate may not be below 25 percent of the adjusted carrying value of the investment as reflected on the FHC's balance sheet.<sup>88</sup> As noted previously, revised risk-based capital standards for banking entities have also been implemented and do, in part, address the risks arising from merchant banking activities.<sup>89</sup>

### *Complementary Activities*

As noted previously, the Board has approved by order four types of activities as complementary to financial activities: physical commodities trading activities, energy management services, energy tolling, and disease management and mail order pharmacy services.<sup>90</sup> The BHC Act permits FHCs to engage in any activity that the Board determines is complementary to a financial activity and does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.<sup>91</sup> As noted in its orders approving complementary activities, this authority is intended to allow the Board to permit FHCs to engage on a limited basis in activities that, although not financial in nature, are so meaningfully connected to financial activity that they complement those activities.<sup>92</sup> The Board accordingly has imposed restrictions to limit the size and scope of such activities and to address the risks associated with the conduct of each activity in each order approving an activity as a complementary activity.<sup>93</sup>

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<sup>87</sup> The holding period for a merchant banking investment in a qualifying private equity fund is up to 15 years. The Board's regulations include special "tacking" provisions to prevent an FHC from circumventing these holding periods by providing that, for purposes of calculating compliance with the merchant banking holding periods, an investment the FHC acquires under another authority that imposes a restriction on the amount of time that the FHC may hold the investment is considered to have been acquired on the original acquisition date. See 12 CFR 225.172(b)(2) and (3).

<sup>88</sup> 12 CFR 225.172(b)(6).

<sup>89</sup> 12 CFR 217.52-53; 217.153-154.

<sup>90</sup> The Board's determination regarding disease management and mail order pharmacy services was in response to the FDIC; the Board has not approved a request by an FHC to engage in disease management or mail order pharmacy services.

<sup>91</sup> 12 USC 1843(k)(1)(B).

<sup>92</sup> See, e.g., Citigroup Inc., 89 Fed. Res. Bull. 508, 509 (2003); see also 145 Cong. Rec. H11529 (daily ed. November 4, 1999) (statement of Chairman Leach) ("It is expected that complementary activities would not be significant relative to the overall financial activities of the organization.").

<sup>93</sup> This report discusses the nature and kinds of restrictions the Board has imposed to address the risks associated with an activity in connection with finding the activity to be a complementary activity. The report does not provide an exhaustive summary of each order that the Board has issued in connection with approving an activity as a complementary activity.

### Physical Commodities Trading Activities

The Board determined that the purchase and sale of commodities in the spot market and taking and making delivery of physical commodities to settle commodity derivatives—physical commodities trading activities—are complementary to the financial activity of commodities derivatives activities that BHCs are permitted to conduct under section 4(c)(8) of the BHC Act and the Board’s Regulation Y.<sup>94</sup> Physical commodities trading exposes FHCs to risks in addition to those associated with commodity derivatives activities, such as legal and environmental risks.

To limit the potential risks of physical commodity trading activities, the Board has conditioned the authority of an FHC to engage in these activities. In particular, FHCs are not authorized to (i) own, operate, or invest in facilities for extraction, transportation, storage, or distribution of commodities or (ii) process, refine, or otherwise alter commodities. In conducting its physical commodity trading activities, an FHC is expected to use appropriate storage and transportation facilities owned and operated by third parties. The Board has also limited the amount of physical commodity trading activities by, for example, limiting the market value of commodities held by an FHC as a result of physical commodity trading activities to no more than 5 percent of the company’s consolidated tier 1 capital.<sup>95</sup> To prevent FHCs from dealing in non-fungible or illiquid goods, the Board also has limited the FHCs to taking and making delivery of physical commodities for which derivative contracts have been approved for trading on a U.S. futures exchange by the Commodity Futures Trading Commission (CFTC) (unless specifically excluded by the Board) or that have been specifically approved by the Board.<sup>96</sup>

### Energy Tolling and Management Services

The Board has found energy tolling and management services to be activities that are complementary to engaging in BHC-permissible commodity derivatives activities and to providing financial and investment advisory services for derivatives transactions.<sup>97</sup> Energy tolling generally involves paying a power plant owner fixed periodic payments that compensate the owner for its fixed costs in exchange for the right to all or part of the plant’s power output. A primary risk of engaging in energy tolling is that the plant proves to be uneconomical to operate, which occurs when the cost of producing power is greater than the power’s market price. In those cases, the toller has no ability to recover its capacity payments. To limit the potential safety

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<sup>94</sup> See, e.g., Citigroup Inc., 89 Fed. Res. Bull. 508 (2003); see also 12 CFR 225.28(b)(8).

<sup>95</sup> The company is also required to notify its designated supervising Federal Reserve Bank if the market value of commodities held by the company as a result of its commodity trading activities exceeds 4 percent of tier 1 capital.

<sup>96</sup> The Board has also permitted physical trading of certain commodities not approved by the CFTC for trading on a U.S. futures exchange when the derivatives contract based on the commodity is traded on a non-U.S. exchange that is subject to a regulatory structure comparable to the one administered by the CFTC. The Board recognized that a market-maker may not seek CFTC approval for a particular commodity if there is already an established foreign trading market, which may deter a U.S. exchange from listing a product.

<sup>97</sup> Fortis S.A./N.V., 94 Fed. Res. Bull. C20 (2008); the Royal Bank of Scotland Group PLC, 94 Fed. Res. Bull. C60 (2008).

and soundness risks of energy tolling, the Board has limited the amount of an FHC's energy tolling activities (together with the company's physical commodity trading activities) to a maximum of 5 percent of the company's tier 1 capital.

Energy management services generally entail acting as a financial intermediary for a power plant owner to facilitate transactions relating to the acquisition of fuel and the sale of power by the power plant owner and providing advice to assist the owner in developing its risk management plan. To minimize the size, scope, and safety and soundness risks associated with these activities, the Board has conditioned the authority of an FHC to provide energy management services<sup>98</sup> and has limited the amount of revenues that an FHC may derive from energy management services to not more than 5 percent of a company's total consolidated operating revenues.

#### *Disease Management and Mail Order Pharmacy Services*

In 2007, the FDIC requested that the Board determine whether disease management and mail-order pharmacy activities are permissible for FHCs as complementary to the financial activity of underwriting and selling health insurance.<sup>99</sup> Disease management services consist of providing insurance plan members with access to a variety of tools and resources designed to help them maintain healthy lifestyles and properly manage their medical conditions, including, for example, providing vaccinations and health screening and assessments. Mail order pharmacy services entail filling prescriptions for customers who have pharmacy benefit insurance coverage, providing drug-related information to customers, and tracking potential issues with customers' prescriptions, such as drug interactions.<sup>100</sup>

The Board determined that these activities would not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. In making this determination, the Board noted that the FHC maintained liability insurance and provided extensive training to the employees engaged in these activities to ensure compliance with applicable laws and regulations and that the FHC's insured depository institution was not permitted to make loans to, engage in cross-marketing activities with, or have other direct business relationships with the company's subsidiaries that provide disease management and mail-order pharmacy services. Moreover, the FHC's personnel who engaged in conducting disease management and mail-order pharmacy activities were licensed and regulated by appropriate state licensing boards.

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<sup>98</sup> Specifically, the Board has subjected an FHC to conditions that limit the responsibilities and potential liabilities the FHC may assume under the energy management agreement, such as prohibiting the FHC or its affiliates from guaranteeing the financial performance of the facility and requiring that the owner of such facility dictate the level of power output of the facility. Fortis S.A./N.V., 94 Fed. Res. Bull. C20 (2008).

<sup>99</sup> Order Determining that Certain Activities are Complementary to the Financial Activity of Underwriting and Selling Health Insurance, 93 Fed. Res. Bull. C133 (2007).

<sup>100</sup> The Board concluded that there was a reasonable basis for construing these activities as complementary to a financial activity within the meaning of the GLBA because (i) the activities help employers that obtain health insurance from an insurance company to manage and reduce the risks and costs of providing health insurance to employees and (ii) many of the largest health insurers in the United States provide these services to their own insurance customers and to customers of other health insurance companies.

In addition, to limit the potential size, scope, and safety and soundness risks of these activities, the Board conditioned its determination on the requirement that these activities in the aggregate not account for more than 2 percent of an FHC's consolidated total assets or 5 percent of its consolidated total annual revenues. The Board also limited the total assets of an FHC's subsidiaries engaged in these activities to an aggregate limit of 5 percent or less of the total capital (calculated in accordance with applicable statutory accounting principles) of all regulated insurance company subsidiaries and health plans of the company. Moreover, any extension of credit, or other covered transactions, between the FHC's insured depository institution and its affiliates must also comply with section 23A and 23B of the FRA and the Board's Regulation W.

### *Section 4(o) Commodities Activities*

As noted previously, only two firms are eligible to rely on section 4(o) authority to engage in commodities related activities. In contrast to complementary authority, this grandfather authority is automatic; no approval by or notice to the Board is required for a company to rely on section 4(o) to conduct its commodity activities. This statutory grandfathering authority permits certain FHCs to engage in a potentially broader set of physical commodity activities than may be conducted under the complementary authority, such as storing, transporting, and extracting commodities, and without the conditions that the Board has placed on engaging in complementary commodities activities to protect safety and soundness.

Operation of facilities used for the storage, transportation, and extraction of physical commodities expose firms to substantial legal, operational, and environmental risks. In particular, catastrophic and environmental events related to the companies' physical commodities activities may impose losses in amounts that greatly exceed the companies' investments in the underlying physical assets, the market value of the physical commodities involved in the catastrophic event, committed capital, and insurance policies of the organization. A variety of catastrophic and environmental events in recent years have highlighted the danger of underappreciated tail risks associated with conducting physical commodities activities and shown that the actions firms may take to limit these risks are more limited.

### *Further Review of Risks Associated with Physical Commodities Activities*

In light of the risks associated with physical commodities activities and in addition to the steps the Board has taken to improve the framework for financial supervision and regulation of holding companies,<sup>101</sup> the Board has undertaken a review of FHCs' commodities investments and activities under 4(k) complementary authority, merchant banking authority, and 4(o) grandfather authority. In January 2014, the Board invited public comment through an advance notice of proposed rulemaking (ANPR) on a range of issues related to the commodities activities

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<sup>101</sup> As noted previously, the Board has implemented enhanced prudential standards under section 165 of Dodd-Frank "to prevent or mitigate risks to the financial stability of the United States." 12 CFR 252. The Board also adopted a revised capital framework for banking entities supervised by the Federal Reserve that increases the overall quantity and quality of capital in the banking system. 12 CFR 217.

of FHCs.<sup>102</sup> As explained in the ANPR, the Board is exploring what further prudential restrictions or limitations on the ability of FHCs to engage in commodities-related activities are warranted to mitigate the risks associated with these activities. The Board also is exploring what prudential restrictions or limitations on investments made through the merchant banking authority would appropriately address those or similar risks. This process is ongoing.

## Recommendations

As noted previously, section 620 of Dodd–Frank requires this report to include recommendations regarding (i) whether each activity or investment has or could have a negative effect on the safety and soundness of the banking entity or the U.S. financial system, (ii) the appropriateness of the conduct of each activity or type of investment by banking entities, and (iii) additional restrictions as may be necessary to address risks to safety and soundness arising from the permissible activities or types of investments of banking entities.

The Board is recommending 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.<sup>103</sup> These changes require congressional action and cannot be accomplished by the Board unilaterally. In particular, the Board recommends that Congress

- repeal the authority of FHCs to engage in merchant banking activities;
- repeal the grandfather authority for certain FHCs to engage in commodities activities under section 4(o) of the BHC Act;
- repeal the exemption that permits corporate owners of industrial loan companies (ILC) to operate outside of the regulatory and supervisory framework applicable to other corporate owners of insured depository institutions; and
- repeal the exemption for GUSLHCs from the activities restrictions applicable to all other SLHCs.

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<sup>102</sup> See Federal Reserve System, “Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities,” 79 Fed. Reg. 3329 (January 21, 2014).

<sup>103</sup> Although the Board has taken a number of important steps to address the risks to safety and soundness arising from the activities and investments of banking entities supervised by the Board, the Board’s recommendations do not discuss these efforts in detail. For example, the Board approved a final rule to establish minimum margin requirements for swaps and security-based swaps that are not cleared through a clearinghouse. “Margin and Capital Requirements for Covered Swap Entities,” 80 Fed. Reg. 74840 (November 30, 2015). Additionally, the Board and other federal banking agencies have issued guidance regarding sound practices for leveraged finance activities. “[Interagency Guidance on Leveraged Lending](#),” SR 13-3 (March 21, 2013). The Board also has taken steps to improve the resiliency of Board-regulated institutions more generally. For example, the Board adopted enhanced prudential standards that include risk-based and leverage capital requirements, requirements for overall risk management, and stress testing. The Board also approved a final rule to implement a risk-based capital surcharge for firms identified as global systemically important BHCs, or GSIBs.

These recommended changes would better align the activities and investments of, as well as the regulatory and supervisory framework governing, regulated financial institutions and corporate owners of insured depository institutions. In doing so, these changes would create a more level playing field among regulated financial institutions and owners of insured depository institutions. Additionally, many of these changes would further limit the commercial activities of banking entities and, as a result, help to enhance safety and soundness, minimize the concentration of economic resources by limiting an institution's ability to take on risk associated with commercial activities, and help ensure the separation of banking and commerce.

## Repeal of Section 4(o) of the BHC Act

As noted, 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 such as the storage, transportation, and extraction of commodities. This grandfathered authority raises safety and soundness concerns as well as competitive issues, as it is currently available to only two firms. In addition, this grandfather provision is inconsistent with the separation of banking and commerce.

As noted earlier, section 4(o) does not prohibit FHCs from owning, operating, or investing in facilities for the extraction, transportation, storage, or distribution of commodities, or from processing or refining commodities. Certain federal environmental laws impose strict liability on the owners and operators of facilities and vessels that release many physical commodities, such as oil, distillate fuel oil, jet fuel, liquefied petroleum gas, and gasoline, fertilizer, and natural gas.<sup>104</sup> Consequently, physical commodities activities permitted pursuant to section 4(o) may expose such firms to liability arising from environmental catastrophes, which can create material financial and legal harm for these firms or could harm public confidence in and access to funding markets for the firm or its subsidiary insured depository institution.<sup>105</sup>

Section 4(o) authority may create an unlevel playing field between these firms and most other banking organizations, including FHCs that engage in physical commodities activities through complementary authority. As some commenters to the Board's ANPR have noted, these activities may allow the firms to obtain important information on conditions in the physical markets, such as the amount and timing of production, through their engagement in activities

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<sup>104</sup> See letter from the Securities Industry and Financial Markets Association et al., dated April 16, 2014; 33 USC 1321, 2701-02; 42 USC 7412, 7420, 9607.

<sup>105</sup> Liability under federal and state law may attach to FHCs that own physical commodities involved in catastrophic events even if the FHCs hire third parties to store and transport the commodities. Moreover, the Board has noted that recent disasters involving physical commodities suggest FHCs' vendor approval processes and current industry safety policies and procedures may not prevent a major environmental disaster and may call into question the effectiveness of such procedures. To the extent a nonbanking subsidiary of an FHC is liable for all or part of such damages, the FHC may also be held liable to the same extent as the subsidiary if the corporate veil between the parent and subsidiary is pierced. See Federal Reserve System, "Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies Related to Physical Commodities," 79 Fed. Reg. 3329 (January 21, 2014).

such as power generation, shipping, storage, pipelines, mining, and other industrial activities.<sup>106</sup> Further, while the statute places a limit on the aggregate amount of activities that may be conducted under section 4(o),<sup>107</sup> this limit is much less restrictive than the limit placed by the Board on physical commodities activities conducted under complementary authority.<sup>108</sup> In addition, in contrast to complementary authority, 4(o) grandfather authority is automatic; no approval by or notice to the Board is required for a company to rely on this authority for its commodity activities.<sup>109</sup>

Because section 4(o) also authorizes certain FHCs to engage directly in a potentially broader range of commercial activities, the section also undercuts the general separation of banking and commerce. That separation is important to ensuring a sound, efficient, and objective banking system that allocates credit and provides services on a fair and equitable basis.<sup>110</sup> The separation also helps to prevent undue economic concentration that can have a disproportionate effect on financial markets, production, and employment if failure occurs.

In light of the foregoing, the Board recommends repeal of section 4(o) of the BHC Act with an appropriate transition period to permit the affected firms sufficient time to wind down their existing activities under this authority and thereby minimize any potential economic disruption.

## Repeal of Merchant Banking Authority

Under merchant banking authority, FHCs may make investments in nonfinancial companies as part of a bona fide merchant or investment banking activity. These investments may include a

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<sup>106</sup> Letter from Senator Carl Levin dated April 16, 2014; U.S. Senate Permanent Subcommittee on Investigations, *Wall Street Bank Involvement with Physical Commodities* 10, 390–96 (November 20, 2014).

<sup>107</sup> This statutory provision limits activities conducted under 4(o) to no more than 5 percent of the FHC's total consolidated assets and prohibits the FHC from cross-marketing the services of its subsidiary depository institution(s) and its subsidiary(ies) engaged in activities authorized under section 4(o).

<sup>108</sup> In contrast to 4(o) authority, complementary authority limits an FHC's commodities holdings to 5 percent of tier 1 capital. The limit was intended to ensure that complementary commodities activities would not be significant relative to the overall financial activities of the organization. See, e.g., Citigroup Inc., 89 Fed. Res. Bull. 508 (2003) (2003 Citi Order); see also 145 Cong. Rec. H. 11529 (daily ed. November 4, 1999) (statement of Chairman Leach) ("It is expected that complementary activities would not be significant relative to the overall financial activities of the organization.").

<sup>109</sup> In connection with any proposal by an FHC to engage in a complementary activity, the Board must consider whether performance of the activity by the FHC may reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, unsound banking practices, or risk to the stability of the U.S. banking or financial system. 12 USC 1843(j).

<sup>110</sup> See, e.g., Bank Holding Legislation: Hearing before the S. Comm. on Banking & Currency-Part 1, 83d Cong. 14-43 (1953) (statements of William McChesney Martin, Chairman, Board of Governors, and J. L. Robertson, Member, Board of Governors); Providing for Control & Regulation of Bank Holding Companies: Hearing before the S. Comm. on Banking & Currency, 80th Cong. 9-23, 162-71 (1947) (statement of Marriner Eccles, Chairman, Board of Governors).

variety of ownership interests in any type of nonfinancial company, including portfolio companies engaged in physical commodities activities. In addition, these investments may be in any amount, from only a nominal number of shares up to all the ownership interest, of a portfolio company.

The current merchant banking regulations issued by the Board and the U.S. Department of the Treasury work to ensure that FHCs' investments are bona fide, financial investments and that corporate separateness is maintained between the FHC and portfolio company. Corporate separateness helps ensure the limited liability nature of an FHC's investment in a portfolio company. For example, the general prohibition against routine management in the BHC Act and the current merchant banking regulations help ensure that an FHC does not participate in the day-to-day management of a portfolio company, which could expose the FHC to liability. Moreover, the merchant banking regulations also require FHCs engaged in merchant banking activities to establish risk management policies and procedures for such activities, specifically including those designed to ensure the maintenance of corporate separateness between the FHC and the portfolio company.<sup>111</sup>

Under the GLBA, an FHC may routinely manage or operate a portfolio company as may be necessary or required to obtain a reasonable return on the resale or disposition of the investment. By involving itself in the operations of a portfolio company in these circumstances, an FHC exposes itself to increased risks of being legally liable for the operations of the portfolio company when a portfolio company is less likely to be able to satisfy the claims of creditors and tort claimants. For example, if the portfolio company is involved in an environmental event that causes significant losses, the FHC that has routinely managed the portfolio company during the environmental event may also be exposed to substantial legal and environmental risk.

The Board recommends that Congress repeal merchant banking authority.<sup>112</sup> While the Board has taken regulatory actions to limit the potential risks arising from merchant banking activities, the existing statutory merchant banking authority enables FHCs to engage in activities that pose risks to the organizations' safety and soundness. Absent merchant banking authority, FHCs would generally not be able to own up to 100 percent of the ownership interest of a nonfinancial portfolio company or be involved in the routine management of the company. This would prevent FHCs from investing in nonfinancial companies and from becoming exposed to the risk of legal liability for the operations of a portfolio company. Thus, a repeal of merchant banking authority would help address potential safety and soundness concerns and maintain the basic tenet of separation of banking and commerce.

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<sup>111</sup> 12 CFR 225.175(a)(1)(iv).

<sup>112</sup> The Board is currently considering regulatory measures that would limit the safety and soundness risks of merchant banking investments and ensure that FHCs engaged in merchant banking adequately account for the risks associated with such investments.



## Repeal of the Exemptions for GUSLHCs and Corporate Owners of Industrial Loan Companies

As discussed above, the BHC Act and HOLA provide federal frameworks for the supervision and regulation of companies that own or control banks and thrifts. These comprehensive frameworks are intended to help protect the safety and soundness of corporately controlled banks and thrifts that have access to the federal safety net and to maintain the general separation of banking and commerce in the United States. They do so principally in two ways. First, the BHC Act and HOLA provide for all BHCs and SLHCs, including those that are FHCs, to be supervised on a consolidated or group-wide basis by the Federal Reserve. Second, the acts prevent BHCs and SLHCs from engaging in general commercial activities. Instead, as discussed previously, the acts allow BHCs and SLHCs that are FHCs to engage only in activities that Congress or the Board (in consultation with the Treasury Department, in certain cases) has determined to be financial in nature or incidental or complementary to a financial activity. The acts also require as a condition for engaging in broad securities underwriting, insurance, and other financial activities that the FHC and its depository institution subsidiaries meet enhanced financial and managerial standards and that the depository institution subsidiaries also maintain satisfactory CRA performance.

### *The Nature of the ILC and GUSLHC Exemptions and Their Policy Implications*

ILCs are state-chartered banks that have virtually all of the powers and privileges of other insured commercial banks, including the protections of the federal safety net: deposit insurance and access to the Federal Reserve's discount window and payments system. Nonetheless, ILCs, as defined in the BHC Act, are not included within the definition of the term "bank" under the act. As a result, any type of firm, including a commercial firm or foreign bank, may acquire and operate an ILC without complying with the standards that Congress has established for BHCs to maintain the separation of banking and commerce and to protect insured banks, the federal safety net and, ultimately, the taxpayer.<sup>113</sup> Similarly, as noted above, a sizable number of commercial firms that had acquired or were in the process of acquiring a federally insured savings association at the time the GLBA was passed enjoy an exemption that permits these companies to continue to engage in an unlimited array of activities.<sup>114</sup>

The continuation of the ILC and GUSLHC exemptions undermines several fundamental policies that Congress has established and reaffirmed governing the structure, supervision, and regulation of the financial system. In addition, the exemptions foster an unfair and uneven competitive and regulatory playing field by allowing GUSLHCs and corporate owners of ILCs to operate outside the activity restrictions (and in the case of corporate owners of ILCs, the consolidated

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<sup>113</sup> See 12 USC 1841(c)(2)(H). ILCs are regulated and supervised by the FDIC and their chartering state in the same manner as other types of state-chartered, nonmember insured banks, and the Board has no concerns about the adequacy of this existing supervisory framework for ILCs themselves.

<sup>114</sup> 12 USC 1467a(c)(3).

supervisory and regulatory framework) that apply to other community-based, regional, and diversified organizations that own a similarly situated bank.

### *Affiliation of Commercial Entities*

For many years, Congress has sought to maintain the general separation of banking and commerce in the United States out of concern that the mixing of banking and commerce might, in effect, extend the federal safety net to commercial entities and make insured banks susceptible to the reputational, operational, and financial risks of their commercial affiliates. Congress also expressed concern that allowing banks and commercial firms to affiliate with each other could lead to the concentration of economic power in a few very large conglomerates.<sup>115</sup> By allowing commercial firms to affiliate with insured depository institutions, the ILC and GUSLHC exemptions undermine the policy of maintaining the separation of banking and commerce.

### *Affiliation of Financial Entities*

As noted above, BHCs and SLHCs may engage in a broad range of financial activities, including securities underwriting, various insurance activities, and merchant banking, *only* if the holding company is well capitalized and well managed, keeps all of its subsidiary depository institutions well capitalized and well managed, and achieves and maintains at least a satisfactory CRA record at all of the company's subsidiary insured depository institutions. These requirements help ensure that banks and savings associations operating within a diversified financial company remain financially and managerially strong and help meet the credit needs of the communities they serve, including low- and moderate-income families and communities. The ILC and GUSLHC exemptions are inconsistent with these requirements because they allow firms to own and operate FDIC-insured institutions without abiding by the CRA requirements and enhanced capital and managerial standards noted previously.

### *Consolidated Supervision and Regulation*

In addition, the ILC exemption creates special supervisory risks because an ILC's parent company and nonbank affiliates are not subject to consolidated supervision. Lack of consolidated supervision is problematic because the organization may operate and manage its businesses on an integrated basis, and, in the Federal Reserve's experience, risks that cross legal entities and that are managed on a consolidated basis cannot be monitored properly through supervision

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<sup>115</sup> See S. Rep. No. 100-19 (1987); S. Rep. No. 91-1084 (1970); H.R. Rep. No. 84-609 (1955). Congress reaffirmed its desire to maintain the general separation of banking and commerce as recently as 1999, when it passed the GLBA. That act amended HOLA to end the exception that allowed commercial firms to acquire a federally insured savings association. At the same time and after lengthy debate, Congress decided to allow FHCs to engage in *only* those activities determined to be financial in nature or incidental or complementary to financial activities. In fact, in passing the GLBA, Congress rejected earlier proposals that would have allowed FHCs to engage generally in a "basket" of commercial activities or that would have allowed commercial firms to acquire a small bank without becoming subject to the BHC Act. The GLBA did provide certain nonbanking firms that became FHCs after November 1999 up to 10 years to *divest* their impermissible commercial holdings if the firm was and remained "predominantly financial." See 12 USC 1843(n). All commercial investments held under this authority were required to be divested no later than November 12, 2009.

directed at any one, or even several, of the legal entity subdivisions within the overall organization. Moreover, history demonstrates that financial distress in one part of a business organization can spread, sometimes rapidly, to other parts of the organization.

Consolidated supervision is especially helpful in mitigating the risks to the federal safety net when an ILC is closely integrated with, or heavily reliant on, its parent organization. In these situations, the ILC may have no business independent of its affiliates, and its loans and deposits may be derived or solicited largely through or from affiliates. In addition, the ILC may be substantially or entirely dependent on the parent or its affiliates for critical services, such as computer support, treasury operations, accounting, and for personnel, management, and even premises.<sup>116</sup>

It must also be noted that consolidated supervision is a prerequisite for foreign banks seeking to acquire an insured depository institution in the United States. Following the collapse of the Bank of Credit and Commerce International—a foreign bank that lacked a single supervisor capable of monitoring its global activities—Congress amended the BHC Act to require that, before a foreign bank may acquire a U.S. bank or establish a branch, agency, or commercial lending company subsidiary in the United States, the Board must determine that the foreign bank is subject to comprehensive supervision on a consolidated basis in its home country. The ILC exemption, however, allows a foreign bank that is not subject to consolidated supervision in its home country to avoid this requirement and acquire an insured depository institution with broad deposit-taking and lending powers.

### *Competitive Concerns*

The ILC and GUSLHC exemptions also create an uneven playing field among organizations that control an FDIC-insured institution because they allow the corporate owners of ILCs and GUSLHCs to operate under a substantially different framework than the owners of other insured institutions. These advantages provide incentives for firms to continue to exploit the exemptions and maintain opportunities for “regulatory arbitrage.” Over time, such actions could lead to shifts in the structure and supervision of the financial system and the Federal Reserve’s and other regulatory authorities’ ability to prevent or respond quickly to a financial crisis.

Accordingly, the Board recommends that Congress repeal the ILC and GUSLHC exemptions in current law and require that all corporate owners of FDIC-insured depository institutions be subject to the restrictions, regulatory requirements, and supervisory frameworks of either the BHC Act or HOLA, as appropriate. Doing so would build upon and use the existing regulatory

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<sup>116</sup> Because of the ILC exemption, the parent companies of ILCs are not subject to the consolidated capital requirements established for BHCs and are not required to serve as sources of strength to their subsidiary ILCs. Indeed, among the factors contributing to the failure of a federally insured ILC in 1999 were the unregulated borrowing and weakened capital position of the corporate owner of the ILC and the inability of any federal supervisor to ensure that the parent holding company remained financially strong. It must also be noted that the companies that failed or required assistance at the outset of the 2008 financial crisis included a number of companies that owned and controlled ILCs.

and supervisory frameworks for the corporate owners of banks and thrifts and create a level playing field for all firms that acquire an FDIC-insured institution in the future. However, for reasons of fairness and to avoid potential economic disruption, the Board recommends that existing companies that rely on the GUSLHC and ILC exemptions be given the appropriate amount of time—a number of years—to conform their activities to the requirements of either the BHC Act or HOLA, as appropriate.

# Appendix 1: Exceptions to the Nonbanking Prohibitions of Section 4 of the BHC Act

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Section 4 of the BHC Act generally prohibits a BHC from acquiring “ownership or control of...any company which is not a bank” or engaging “in any activity other than those of banking or of managing or controlling banks and other subsidiaries authorized under th[e] Act.” Section 4(c) of the BHC Act provides limited exceptions to the general prohibition on nonbanking activities to permit BHCs to:

1. Invest in a company engaged in holding or operating properties used wholly or substantially by any <b>banking</b> subsidiary of such BHC in the operations of such banking subsidiary or acquired for such future use; conduct safe deposit business or acquire shares of a company whose activities are limited to conducting such business; invest in a company which furnishes services to or performs services for the BHC or its banking subsidiaries; or own shares of a company which engages in liquidating assets acquired from such BHC (excluding its nonbank subsidiaries) or its banking subsidiaries, or which were acquired from any other source prior to May 9, 1956, or the date on the holding company became a BHC, whichever is later. 12 USC 1843(c)(1).
2. Acquire, directly or indirectly, shares (or other assets and real estate) in satisfaction of debt previously contracted (“DPC”) in good faith. 12 USC 1843(c)(2).
3. Acquire shares or real estate from any of its subsidiaries if a subsidiary had been requested to dispose of the shares by any federal/state authority having the power to examine the subsidiary. 12 USC 1843(c)(3).
4. Hold or acquire shares, indirectly through a bank or trust company subsidiary, in good faith in a fiduciary capacity. 12 USC 1843(c)(4).
5. Own shares of the kind and in amounts eligible for investments by a national bank under the provisions of section 5136 of the Revised Statutes. 12 USC 1843(c)(5) (Section 5136 is a broad statute with types of permissible activities both explicitly defined and implied indirectly without express definition. To limit the need for constant Board interpretation regarding the implied areas of section 5136, the Board, through section 225.22(d) of Regulation Y, limits BHCs’ acquisition under this exemption to shares that are explicitly authorized by any federal statute).
6. Acquire shares of any nonbank company that do not exceed 5 percent of the outstanding voting shares of such company. 12 USC 1843(c)(6).
7. Own any amount of the shares of an investment company provided that the investment company is not itself a BHC and is only engaged in the business of investing in securities, which securities do not include more than 5 percent of any class of voting shares of any company. 12 USC 1843(c)(7).
8. Engage in activities that were determined to be “so closely related to banking...as to be a proper incident thereto,” prior to November 12, 1999. 12 USC 1843(c)(8).
9. Continue to own, directly or through a wholly-owned subsidiary, nonbank shares which were lawfully acquired and owned directly/indirectly prior to May 9, 1956. 12 USC

1843(c)(10).
10. Invest, directly/indirectly, in an amount not exceeding 5 percent of the BHC's consolidated capital and surplus, in shares of any company that is an export trading company. 12 USC 1843(c)(14).
11. Have a qualified savings bank subsidiary, which may engage directly or indirectly in any nonbanking activity, except certain insurance activities, that it is permitted to engage in by state law—including activities which are not otherwise permitted for banking companies as “so closely related to banking...as to be a proper incident thereto” under section 4(c)(8) of the BHC Act. 12 USC 1843(f).
12. Engage in international activities by investing in companies that do no business in the United States except what is incidental to such companies' international or foreign business if the Board determines that it would not be substantially at variance with the purpose of the BHC Act and would be in the public interest. 12 USC 1843(c)(13).

# Appendix 2: Activities Determined to be Closely Related to Banking Under Section 4(c)(8) of the BHC Act (Section 225.28(b) of the Board's Regulation Y)

<b>Activities</b>
<p>(1) <i>Extending credit and servicing loans.</i> Making, acquiring, brokering, or servicing loans or other extensions of credit (including factoring, issuing letters of credit and accepting drafts) for the company's account or for the account of others.</p>
<p>(2) <i>Activities related to extending credit.</i> Any activity usual in connection with making, acquiring, brokering or servicing loans or other extensions of credit, as determined by the Board. The Board has determined that the following activities are usual in connection with making, acquiring, brokering or servicing loans or other extensions of credit:</p> <ul style="list-style-type: none"> <li>(i) <i>Real estate and personal property appraising.</i> Performing appraisals of real estate and tangible and intangible personal property, including securities.</li> <li>(ii) <i>Arranging commercial real estate equity financing.</i> Acting as intermediary for the financing of commercial or industrial income-producing real estate by arranging for the transfer of the title, control, and risk of such a real estate project to one or more investors, if the bank holding company and its affiliates do not have an interest in, or participate in managing or developing, a real estate project for which it arranges equity financing, and do not promote or sponsor the development of the property.</li> <li>(iii) <i>Check-guaranty services.</i> Authorizing a subscribing merchant to accept personal checks tendered by the merchant's customers in payment for goods and services, and purchasing from the merchant validly authorized checks that are subsequently dishonored.</li> <li>(iv) <i>Collection agency services.</i> Collecting overdue accounts receivable, either retail or commercial.</li> <li>(v) <i>Credit bureau services.</i> Maintaining information related to the credit history of consumers and providing the information to a credit grantor who is considering a borrower's application for credit or who has extended credit to the borrower.</li> <li>(vi) <i>Asset management, servicing, and collection activities.</i> Engaging under contract with a third party in asset management, servicing, and collection of assets of a type that an insured depository institution may originate and own, if the company does not engage in real property management or real estate brokerage services as part of these services.</li> <li>(vii) <i>Acquiring debt in default.</i> Acquiring debt that is in default at the time of acquisition, if the company: <ul style="list-style-type: none"> <li>(A) Divests shares or assets securing debt in default that are not</li> </ul> </li> </ul>

<p>permissible investments for bank holding companies, within the time period required for divestiture of property acquired in satisfaction of a debt previously contracted under § 225.12(b);</p> <p>(B) Stands only in the position of a creditor and does not purchase equity of obligors of debt in default (other than equity that may be collateral for such debt); and</p> <p>(C) Does not acquire debt in default secured by shares of a bank or bank holding company.</p> <p>(viii) <i>Real estate settlement servicing. Providing real estate settlement services.</i></p>
<p>(3) <i>Leasing personal or real property.</i> Leasing personal or real property or acting as agent, broker, or adviser in leasing such property if:</p> <p>(i) The lease is on a nonoperating basis;</p> <p>(ii) The initial term of the lease is at least 90 days;</p> <p>(iii) In the case of leases involving real property:</p> <p>(A) At the inception of the initial lease, the effect of the transaction will yield a return that will compensate the lessor for not less than the lessor's full investment in the property plus the estimated total cost of financing the property over the term of the lease from rental payments, estimated tax benefits, and the estimated residual value of the property at the expiration of the initial lease; and</p> <p>(B) The estimated residual value of property for purposes of paragraph (b)(3)(iii)(A) of this section shall not exceed 25 percent of the acquisition cost of the property to the lessor.</p>
<p>(4) <i>Operating nonbank depository institutions—</i></p> <p>(i) <i>Industrial banking.</i> Owning, controlling, or operating an industrial bank, Morris Plan bank, or industrial loan company, so long as the institution is not a bank.</p> <p>(ii) <i>Operating savings association.</i> Owning, controlling, or operating a savings association, if the savings association engages only in deposit-taking activities, lending, and other activities that are permissible for bank holding companies under this subpart C.</p>
<p>(5) <i>Trust company functions.</i> Performing functions or activities that may be performed by a trust company (including activities of a fiduciary, agency, or custodial nature), in the manner authorized by federal or state law, so long as the company is not a bank for purposes of section 2(c) of the Bank Holding Company Act.</p>
<p>(6) <i>Financial and investment advisory activities.</i> Acting as investment or financial advisor to any person, including (without, in any way, limiting the foregoing):</p> <p>(i) Serving as investment adviser (as defined in section 2(a)(20) of the Investment Company Act of 1940, 15 USC 80a-2(a)(20), to an investment company registered under that act, including sponsoring, organizing, and managing a closed-end investment company;</p> <p>(ii) Furnishing general economic information and advice, general economic statistical forecasting services, and industry studies;</p> <p>(iii) Providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, capital structurings, financing transactions and similar transactions, and conducting</p>



financial feasibility studies;

(iv) Providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments;

(v) Providing educational courses, and instructional materials to consumers on individual financial management matters; and

(vi) Providing tax-planning and tax-preparation services to any person.

(7) *Agency transactional services for customer investments—*

(i) *Securities brokerage.* Providing securities brokerage services (including securities clearing and/or securities execution services on an exchange), whether alone or in combination with investment advisory services, and incidental activities (including related securities credit activities and custodial services), if the securities brokerage services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting or dealing.

(ii) *Riskless principal transactions.* Buying and selling in the secondary market all types of securities on the order of customers as a “riskless principal” to the extent of engaging in a transaction in which the company, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer. This does not include:

(A) Selling bank-ineligible securities at the order of a customer that is the issuer of the securities, or selling bank-ineligible securities in any transaction where the company has a contractual agreement to place the securities as agent of the issuer; or

(B) Acting as a riskless principal in any transaction involving a bank-ineligible security for which the company or any of its affiliates acts as underwriter (during the period of the underwriting or for 30 days thereafter) or dealer.

(iii) *Private placement services.* Acting as agent for the private placement of securities in accordance with the requirements of the Securities Act of 1933 (1933 Act) and the rules of the Securities and Exchange Commission, if the company engaged in the activity does not purchase or repurchase for its own account the securities being placed, or hold in inventory unsold portions of issues of these securities.

(iv) *Futures commission merchant.* Acting as a futures commission merchant (FCM) for unaffiliated persons in the execution, clearance, or execution and clearance of any futures contract and option on a futures contract traded on an exchange in the United States or abroad if:

(A) The activity is conducted through a separately incorporated subsidiary of the bank holding company, which may engage in activities other than FCM activities (including, but not limited to, permissible advisory and trading activities); and

(B) The parent bank holding company does not provide a guarantee or otherwise become liable to the exchange or clearing association other

than for those trades conducted by the subsidiary for its own account or for the account of any affiliate.

(v) *Other transactional services.* Providing to customers as agent transactional services with respect to swaps and similar transactions, any transaction described in paragraph (b)(8) of this section, any transaction that is permissible for a state member bank, and any other transaction involving a forward contract, option, futures, option on a futures or similar contract (whether traded on an exchange or not) relating to a commodity that is traded on an exchange.

(8) *Investment transactions as principal*

(i) *Underwriting and dealing in government obligations and money market instruments.* Underwriting and dealing in obligations of the United States, general obligations of states and their political subdivisions, and other obligations that state member banks of the Federal Reserve System may be authorized to underwrite and deal in under 12 USC 24 and 335, including banker's acceptances and certificates of deposit, under the same limitations as would be applicable if the activity were performed by the bank holding company's subsidiary member banks or its subsidiary nonmember banks as if they were member banks.

(ii) *Investing and trading activities.* Engaging as principal in:

(A) Foreign exchange;

(B) Forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset (including gold, silver, platinum, palladium, copper, or any other metal approved by the Board), nonfinancial asset, or group of assets, other than a bank-ineligible security, if:

(1) A state member bank is authorized to invest in the asset underlying the contract;

(2) The contract requires cash settlement;

(3) The contract allows for assignment, termination, or offset prior to delivery or expiration, and the company—

(i) Makes every reasonable effort to avoid taking or making delivery of the asset underlying the contract; or

(ii) Receives and instantaneously transfers title to the underlying asset, by operation of contract and without taking or making physical delivery of the asset; or

(4) The contract does not allow for assignment, termination, or offset prior to delivery or expiration and is based on an asset for which futures contracts or options on futures contracts have been approved for trading on a U.S. contract market by the Commodity Futures Trading Commission, and the company—

(i) Makes every reasonable effort to avoid taking or making delivery of the asset underlying the contract; or

(ii) Receives and instantaneously transfers title to the underlying asset, by operation of contract and without taking or making physical delivery of the asset.

(D) Forward contracts, options, futures, options on futures, swaps, and

similar contracts, whether traded on exchanges or not, based on an index of a rate, a price, or the value of any financial asset, nonfinancial asset, or group of assets, if the contract requires cash settlement.

(iii) *Buying and selling bullion, and related activities.* Buying, selling and storing bars, rounds, bullion, and coins of gold, silver, platinum, palladium, copper, and any other metal approved by the Board, for the company's own account and the account of others, and providing incidental services such as arranging for storage, safe custody, assaying, and shipment.

(9) *Management consulting and counseling activities—*

(i) *Management consulting.*

(A) Providing management consulting advice:

(1) On any matter to unaffiliated depository institutions, including commercial banks, savings and loan associations, savings banks, credit unions, industrial banks, Morris Plan banks, cooperative banks, industrial loan companies, trust companies, and branches or agencies of foreign banks;

(2) On any financial, economic, accounting, or audit matter to any other company.

(B) A company conducting management consulting activities under this subparagraph and any affiliate of such company may not:

(1) Own or control, directly or indirectly, more than 5 percent of the voting securities of the client institution; and

(2) Allow a management official, as defined in 12 CFR 212.2(h), of the company or any of its affiliates to serve as a management official of the client institution, except where such interlocking relationship is permitted pursuant to an exemption granted under 12 CFR 212.4(b) or otherwise permitted by the Board.

(C) A company conducting management consulting activities may provide management consulting services to customers not described in paragraph (b)(9)(i)(A)(1) of this section or regarding matters not described in paragraph (b)(9)(i)(A)(2) of this section, if the total annual revenue derived from those management consulting services does not exceed 30 percent of the company's total annual revenue derived from management consulting activities.

(ii) *Employee benefits consulting services.* Providing consulting services to employee benefit, compensation and insurance plans, including designing plans, assisting in the implementation of plans, providing administrative services to plans, and developing employee communication programs for plans.

(iii) *Career counseling services.* Providing career counseling services to:

(A) A financial organization and individuals currently employed by, or recently displaced from, a financial organization;

(B) Individuals who are seeking employment at a financial organization; and

(C) Individuals who are currently employed in or who seek positions in the finance, accounting, and audit departments of any company.

(10) *Support services*—

- (i) *Courier services*. Providing courier services for:
  - (A) Checks, commercial papers, documents, and written instruments (excluding currency or bearer-type negotiable instruments) that are exchanged among banks and financial institutions; and
  - (B) Audit and accounting media of a banking or financial nature and other business records and documents used in processing such media.
- (ii) *Printing and selling MICR-encoded items*. Printing and selling checks and related documents, including corporate image checks, cash tickets, voucher checks, deposit slips, savings withdrawal packages, and other forms that require Magnetic Ink Character Recognition (MICR) encoding.

(11) *Insurance agency and underwriting*—

- (i) *Credit insurance*. Acting as principal, agent, or broker for insurance (including home mortgage redemption insurance) that is:
  - (A) Directly related to an extension of credit by the bank holding company or any of its subsidiaries; and
  - (B) Limited to ensuring the repayment of the outstanding balance due on the extension of credit<sup>15</sup> in the event of the death, disability, or involuntary unemployment of the debtor.
- (ii) *Finance company subsidiary*. Acting as agent or broker for insurance directly related to an extension of credit by a finance company that is a subsidiary of a bank holding company, if:
  - (A) The insurance is limited to ensuring repayment of the outstanding balance on such extension of credit in the event of loss or damage to any property used as collateral for the extension of credit; and
  - (B) The extension of credit is not more than \$10,000, or \$25,000 if it is to finance the purchase of a residential manufactured home and the credit is secured by the home; and
  - (C) The applicant commits to notify borrowers in writing that:
    - (1) They are not required to purchase such insurance from the applicant;
    - (2) Such insurance does not insure any interest of the borrower in the collateral; and
    - (3) The applicant will accept more comprehensive property insurance in place of such single-interest insurance.
- (iii) *Insurance in small towns*. Engaging in any insurance agency activity in a place where the bank holding company or a subsidiary of the bank holding company has a lending office and that:
  - (A) Has a population not exceeding 5,000 (as shown in the preceding decennial census); or
  - (B) Has inadequate insurance agency facilities, as determined by the Board, after notice and opportunity for hearing.
- (iv) *Insurance-agency activities conducted on May 1, 1982*. Engaging in any specific insurance-agency activity if the bank holding company, or subsidiary conducting the specific activity, conducted such activity on May 1, 1982, or received Board approval to conduct such activity on or before May 1, 1982. A

bank holding company or subsidiary engaging in a specific insurance agency activity under this clause may:

(A) Engage in such specific insurance agency activity only at locations:

- (1) In the state in which the bank holding company has its principal place of business (as defined in 12 USC 1842(d));
- (2) In any state or states immediately adjacent to such state; and
- (3) In any state in which the specific insurance-agency activity was conducted (or was approved to be conducted) by such bank holding company or subsidiary thereof or by any other subsidiary of such bank holding company on May 1, 1982; and

(B) Provide other insurance coverages that may become available after May 1, 1982, so long as those coverages insure against the types of risks as (or are otherwise functionally equivalent to) coverages sold or approved to be sold on May 1, 1982, by the bank holding company or subsidiary.

(v) *Supervision of retail insurance agents.* Supervising on behalf of insurance underwriters the activities of retail insurance agents who sell:

(A) Fidelity insurance and property and casualty insurance on the real and personal property used in the operations of the bank holding company or its subsidiaries; and

(B) Group insurance that protects the employees of the bank holding company or its subsidiaries.

(vi) *Small bank holding companies.* Engaging in any insurance-agency activity if the bank holding company has total consolidated assets of \$50 million or less. A bank holding company performing insurance-agency activities under this paragraph may not engage in the sale of life insurance or annuities except as provided in paragraphs (b)(11) (i) and (iii) of this section, and it may not continue to engage in insurance-agency activities pursuant to this provision more than 90 days after the end of the quarterly reporting period in which total assets of the holding company and its subsidiaries exceed \$50 million.

(vii) *Insurance-agency activities conducted before 1971.* Engaging in any insurance-agency activity performed at any location in the United States directly or indirectly by a bank holding company that was engaged in insurance-agency activities prior to January 1, 1971, as a consequence of approval by the Board prior to January 1, 1971.

(12) *Community development activities*

(i) *Financing and investment activities.* Making equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas by providing housing, services, or jobs for residents.

(ii) *Advisory activities.* Providing advisory and related services for programs designed primarily to promote community welfare.

(13) *Money orders, savings bonds, and traveler's checks.* The issuance and sale at retail of money orders and similar consumer-type payment instruments; the sale of U.S. savings bonds; and the issuance and sale of traveler's checks.

(14) *Data processing.*

(i) Providing data processing, data storage and data transmission services, facilities (including data processing, data storage and data transmission hardware, software, documentation, or operating personnel), databases, advice, and access to such services, facilities, or data-bases by any technological means, if:

(A) The data to be processed, stored or furnished are financial, banking or economic; and

(B) The hardware provided in connection therewith is offered only in conjunction with software designed and marketed for the processing, storage and transmission of financial, banking, or economic data, and where the general purpose hardware does not constitute more than 30 percent of the cost of any packaged offering.

(ii) A company conducting data processing, data storage, and data transmission activities may conduct data processing, data storage, and data transmission activities not described in paragraph (b)(14)(i) of this section if the total annual revenue derived from those activities does not exceed 49 percent of the company's total annual revenues derived from data processing, data storage and data transmission activities.

# Section II: FDIC

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## Introduction

This section of the report primarily covers the activities of state chartered insured banks, with particular focus on state nonmember banks and state savings associations supervised by the FDIC. Congress established the FDIC in the Banking Act of 1933. The FDIC insures deposits at federal and state banks and savings institutions, so that depositors' insured funds are safe and available to them in the event of the failure of an FDIC-insured depository institution. As of September 30, 2015, the FDIC insures the deposits of 6,270 insured depository institutions (IDI) in the United States. The FDIC is the primary federal supervisor for state-chartered banks and savings institutions that are not members of the Federal Reserve System.<sup>117</sup> The FDIC also acts as receiver for IDIs that fail and has resolution planning responsibilities (jointly with the Board) for large and complex financial companies under Dodd–Frank.

Table 2.1:

Primary federal regulator	Number of IDIs	Total assets (millions)
FDIC	3,995	\$2,731,231
OCC	1,431	\$10,790,540
Board	844	\$2,278,447
Total	6,270	\$15,800,219

Source: Third Quarter 2015 Call Report Data.

The FDIC's roles as an insurer and primary supervisor are complementary, and many activities undertaken by the FDIC support both the insurance and supervision programs. Through review of examination reports, use of offsite monitoring tools, and selective participation in examinations conducted by other federal regulators, the FDIC monitors risks at all insured institutions, including those for which it is not the primary federal supervisor. The FDIC also must review and approve applications for deposit insurance from new institutions and certain other applications from IDIs, regardless of the chartering authority.

In particular, as it pertains to the subject of this report, the FDIC must review and approve filings by state-chartered IDIs that seek to conduct activities as principal that are permissible under state law but have not been determined to be permissible for a national bank. On December 19, 1991, the Federal Deposit Insurance Corporation Improvement Act of 1991<sup>118</sup> (FDICIA) was signed into law. Section 303 of the FDICIA added section 24 of the FDI Act, "Activities of Insured State Banks."<sup>119</sup> Section 24 generally limits the activities, as principal, of state-chartered insured

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<sup>117</sup> This includes state-licensed insured branches of foreign banks.

<sup>118</sup> Pub. L. 102-242, 105 Stat. 2236.

<sup>119</sup> See 12 USC 1831a(a).

banks to activities that are permissible for national banks. Similarly, section 28 of the FDI Act generally limits the activities, as principal, of insured state savings associations to those permissible for federal savings associations.<sup>120</sup> In addition, sections 24 and 28 of the FDI Act permit state banks and state savings associations to engage in certain activities that are permissible under state law but that have not been determined to be permissible for a national bank or federal savings association, respectively, if the FDIC determines that the proposed activity would pose no significant risk to the Deposit Insurance Fund and the insured state institution meets and continues to meet applicable capital standards. In part, Part 362 of the FDIC's regulations implements sections 24 and 28 of the FDI Act.<sup>121</sup> The term "activity" includes acquiring or retaining any investment.<sup>122</sup>

For purposes of this section 620 report, the FDIC reviewed 430 of the filings that were submitted to the FDIC under part 362 since 1994.<sup>123</sup> A substantial majority of these filings were requests to engage in various real estate-related activities and investments. Two other important categories of requests, together making up about a quarter of the requests FDIC staff reviewed, related to equity-related activities and investments associated with mineral rights. Slightly more than 10 percent of the filings reviewed dealt with requests to conduct a variety of other activities, none of which, individually, was observed with great frequency. For example, requests to conduct insurance activities composed only about 2 percent of the sample of filings FDIC staff reviewed.

FDIC staff also reviewed the prudential conditions that were imposed in connection with applications approved under part 362. As discussed in more detail in this section of the report, the FDIC has frequently used such prudential conditions as part of its approval process for part 362 applications.

After a comprehensive review of the activities in which state banks and state savings associations may engage, the FDIC identified potential for enhancement, reconsideration, and clarification in several areas of the policy and procedures related to part 362. Specifically, the FDIC plans to:

- review activities related to investments in other financial institutions and other equity investments to evaluate the interaction of existing FDIC regulations and supervisory approvals and conditions under part 362, with other more recent regulatory and statutory rules governing such investments, in order to determine whether changes to part 362 or related procedures with regard to such investments are needed.
- determine whether the prudential conditions and standards under which the FDIC will evaluate part 362 filings with respect to mineral rights, commodities, or other non-traditional activities need to be clarified and, if so, consider issuing a statement of policy pursuant to such review.

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<sup>120</sup> 12 USC 1831e.

<sup>121</sup> See 12 CFR part 362.

<sup>122</sup> 12 USC 1831a(h); 12 USC 1831e(g)(1).

<sup>123</sup> The procedures for filing applications and notices under part 362 are set forth in the FDIC's regulations at 12 CFR part 303, subparts G (state banks) and H (state savings associations).



## Statutory Framework for Activities and Investments of State Banks, State Savings Associations, and Their Subsidiaries

Section 303 of the FDICIA added section 24 of the FDI Act, “Activities of Insured State Banks.”<sup>124</sup> Section 24 limits the activities of state-chartered insured banks to activities that are permissible, as principal, for national banks, absent FDIC approval. State banks are permitted to engage in activities as principal that are not permitted for national banks if the FDIC determines that the activity would not pose significant risk to the Deposit Insurance Fund, if the bank continues to comply with applicable capital standards set by the appropriate federal banking agency, and if the activity is permissible under state law. Because section 24 of the FDI Act applies to activities conducted by state banks “as principal,” state banks may engage in agency and certain other fiduciary activities permitted by state law that otherwise may not be authorized for national banks. The term “activity” includes acquiring or retaining any investment.<sup>125</sup>

### Federal Deposit Insurance Act

#### *Section 24*

With certain exceptions, section 24 of the FDI Act limits the activities of state-chartered insured banks to activities that are permissible for national banks. In addition, if the FDIC determines that the activity poses no significant risk to the Deposit Insurance Fund and if the state bank complies with applicable capital requirements, section 24 permits a state bank and its subsidiaries to engage in activities that have not been determined to be permissible for a national bank and its subsidiaries, as long as the activity is permissible under state law.

Equity investments are afforded different treatment than other activities under section 24. Paragraph (c)(1) of section 24<sup>126</sup> provides that no insured state bank may directly or indirectly acquire or retain any equity investment of a type that is not permissible for a national bank. However, several exceptions to this general prohibition are found in paragraph (c) and in subsequent paragraphs of section 24. For example, the restrictions of paragraph (c)(1) do not prohibit an insured state bank from acquiring or retaining an equity investment in a majority-owned subsidiary of the bank.

Paragraph (d) of section 24<sup>127</sup> governs the activities of subsidiaries of insured state banks. It provides that a subsidiary of an insured state bank may not engage as principal in any type of activity that is not permissible for a subsidiary of a national bank unless the bank meets, and continues to meet, the applicable capital standards as prescribed by the appropriate federal

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<sup>124</sup> See 12 USC 1831a(a).

<sup>125</sup> 12 USC 1831a(h).

<sup>126</sup> See 12 USC 1831a(c).

<sup>127</sup> See 12 USC 1831a(d).

banking agency, and the FDIC determines that the activity will not pose a significant risk to the Deposit Insurance Fund. Paragraph (d)(2)(A) generally prohibits insurance underwriting by subsidiaries of state banks, except to the extent that such activities are permissible for national banks. Paragraph (d)(2)(B) provides an exception to that prohibition. It generally permits well-capitalized insured state banks and their subsidiaries that were providing insurance activities “as principal” in a state on November 21, 1991, to continue to provide the same type of insurance to residents of the state, individuals employed in the state, and any other person to whom the bank or subsidiary provided insurance without interruption since such person resided in or was employed in the state.

Paragraph (e) of section 24<sup>128</sup> indicates that nothing in section 24 shall be construed as prohibiting an insured state bank in Massachusetts, New York, or Connecticut from owning stock in a savings bank life insurance company, provided that consumer disclosures consistent with the Interagency Statement on Retail Sales of Nondeposit Investment Products are made.

Paragraph (f) of section 24<sup>129</sup> governs common and preferred stock investments. It provides that no insured state bank may directly or indirectly acquire or retain any equity investment of a type, or in an amount, that is not permissible for a national bank or is not otherwise permitted under section 24. Paragraph (f) contains several exceptions to the general prohibition.

Paragraph (f)(2) of section 24 created a limited “grandfather” exception for investments in common or preferred stock listed on a national securities exchange or in shares of registered investment companies. The exception allowed insured state banks that (a) were located in a state that as of September 30, 1991, permitted the bank to invest in common or preferred stock listed on a national securities exchange (listed stock) or shares of an investment company registered under the Investment Company Act of 1940<sup>130</sup> (registered shares), and (b) made or maintained investments in listed stock or registered shares during the period from September 30, 1990, to November 26, 1991, to acquire and retain, subject to the FDIC’s approval, listed stock or registered shares to the same extent to which the bank did so during the period from September 30, 1990, to November 26, 1991, up to an aggregate maximum of 100 percent of the bank’s capital. A state bank was required to file a written notice with the FDIC of its intent to take advantage of the exception and to receive the FDIC’s approval before it could lawfully retain or acquire listed stock or registered shares pursuant to the exception provided by paragraph (f)(2). If a bank made investments in listed stock or registered shares during the relevant period that exceeded in the aggregate 100 percent of the bank’s capital as measured on December 19, 1991, the bank was required to divest the excess over the three-year period beginning on December 19, 1991, at a rate of no less than one-third of the excess each year.

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<sup>128</sup> See 12 USC 1831a(e).

<sup>129</sup> See 12 USC 1831a(f).

<sup>130</sup> See 15 USC 80a-1 et seq.

Paragraph (g) of section 24<sup>131</sup> grants the FDIC the authority to make determinations under section 24 by regulation or order, and paragraph (i) indicates that nothing in section 24 shall be construed as limiting the authority of any appropriate federal banking agency or state supervisory authority to impose more stringent restrictions than those set out in section 24.

### *Section 28*

Section 28 of the FDI Act generally prohibits state savings associations from engaging as principal in any type of activity or in any activity in an amount that is not permissible for federal savings associations.<sup>132</sup> Under section 28, the FDIC may permit a state savings association to engage in activities (or to engage in activities in different amounts) not permissible for a federal savings association if the activity is permissible under state law. To permit such activities, the FDIC must determine that the activity poses no significant risk to the Deposit Insurance Fund and that the state savings association complies with applicable capital requirements.<sup>133</sup> Notwithstanding, subsection (c) of section 28 generally prohibits state savings associations from directly or indirectly retaining any equity investment of a type or in an amount that is not permissible for a federal savings association. State savings associations may, however, acquire or retain shares in a service corporation if the FDIC determines that the activity in which the service corporation engages (or the amount that the association proposes to acquire or retain) poses no significant risk to the Deposit Insurance Fund and if the state savings association complies with applicable capital requirements.<sup>134</sup>

### *Section 18*

Section 18(m) of the FDI Act provides that when an insured state savings association establishes or acquires a subsidiary or conducts a new activity through an existing subsidiary, it must first notify the FDIC at least 30 days before the establishment or acquisition of the subsidiary or before the subsidiary commences a new activity.<sup>135</sup>

### *Section 46*

As enacted in the GLBA, section 46(a) of the FDI Act provides that an insured state bank may control or hold an interest in a subsidiary that engages as principal in activities that would be permissible for a national bank to conduct only through a “financial subsidiary,” subject to certain conditions.<sup>136</sup>

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<sup>131</sup> See 12 USC 1831a(g).

<sup>132</sup> See 12 USC 1831e.

<sup>133</sup> The term “activity” includes acquiring or retaining any investment. 12 USC 1831e(g)(1).

<sup>134</sup> See 12 USC 1831e(c)(2).

<sup>135</sup> See 12 USC 1828(m).

<sup>136</sup> 12 USC 1831w(a).

Section 121(a) of the GLBA permits national banks to control or hold an interest in a financial subsidiary, a type of subsidiary governed by section 5136A of the Revised Statutes (National Bank Act).<sup>137</sup> A financial subsidiary may engage in specified authorized activities that are financial in nature and activities that are incidental to financial activities, if the bank and the subsidiary meet certain requirements and comply with stated safeguards. A financial subsidiary also may combine these financial subsidiary activities with activities that are permissible for national banks to engage in directly. The financial subsidiary activities include many of the activities that are authorized for “financial holding companies” in section 4(k) of the BHC Act.<sup>138</sup> The Secretary of the Treasury and the Board may determine that additional activities are financial in nature and, therefore, are authorized for a financial subsidiary of a national bank.

As noted previously, section 46 of the FDI Act permits insured state banks to control or hold an interest in financial subsidiaries subject to four statutory conditions. Such banks also must have a rating of “satisfactory” in meeting community credit needs under the CRA<sup>139</sup> because of section 4(l)(2) of the BHC Act.<sup>140</sup>

## State Banking Laws

For purposes of the FDIC’s approval under the part 362 procedures, state law must allow the institution (or its subsidiary, if applicable) to engage in the proposed activity. State laws governing permissible bank activities are diverse. Depending on the state, permitted activities can include real estate equity participation, real estate development, real estate brokerage, corporate debt and equity securities underwriting, proprietary trading,<sup>141</sup> merchant banking activities, and insurance underwriting. All states have certain “wild card” or parity statutes that grant state banks competitive equality with national banks under applicable federal statutory or regulatory authority. Such authority is provided either (1) through state legislation or regulation, or (2) by authorization of the state banking supervisor. In contrast, 34 states have “wild card” or parity statutes that grant state savings associations competitive equality with federal savings association powers under applicable federal statutory or regulatory authority.

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<sup>137</sup> 12 USC 24a(b).

<sup>138</sup> See 12 USC 1843(k).

<sup>139</sup> See 12 USC 2901 et seq.

<sup>140</sup> See 12 USC 1843(l)(2).

<sup>141</sup> The Volcker Rule (section 619 of Dodd–Frank and section 13 of the BHC Act) generally prohibits banking entities from engaging in short-term proprietary trading of securities, derivatives, commodity futures, and options of these instruments for their own account, subject to certain exemptions.

## Insured Depository Institutions Associated With Parent Companies That Are Not Subject to the BHC Act

The activities of state-chartered banks are governed by federal and state law as described previously. The activities of companies that own banks are, for the most part, governed by the Board pursuant to a statutory framework of consolidated federal supervision. Consolidated federal supervision of companies that own FDIC-insured institutions is an important part of the prudential regulatory framework for banking organizations. As noted in the Board's section of this report, however, a small number of companies that own FDIC-insured institutions have a statutory exemption from consolidated federal supervision.

The FDIC uses its supervisory authorities to mitigate the risks posed to insured depository institutions whose parent companies are not subject to consolidated supervision. In considering applications for deposit insurance, the FDIC uses prudential conditions, as needed, to ensure sufficient autonomy and insulation of the insured depository institution from its parent and affiliates. These conditions are consistent with the conditions imposed by chartering authorities that provide charters for entities that are not defined as "banks" under the BHC Act. In addition, an important focus of the FDIC's examination and supervision program is evaluating and mitigating risk to insured depository institutions from related organizations. This includes examining the insured depository institution for compliance with laws and regulations, including affiliate transaction limits and capital maintenance. During the recent financial crisis, one insured depository institution owned by a parent company not subject to consolidated supervision failed in connection with the failure of its parent organization. Many other insured depository institutions owned by parent companies not subject to consolidated supervision did not fail, even though their parent companies or affiliates failed or experienced severe stress.

## Part 362 Regulations

### Background

Part 362 of the FDIC's regulations implements section 24 of the FDI Act.<sup>142</sup> A comprehensive version of part 362 was adopted in final form in 1993 and subsequently amended in 1998 and 2001.

The 1998 revisions divided part 362 into four subparts in an effort to consolidate the FDIC's regulations governing activities and investments of insured state depository institutions. Subpart A implements section 24 of the FDI Act and addresses the activities of insured state banks. Subpart B applies only to insured state nonmember banks, provides safety and soundness rules, and sets out certain prudent separations that must be present between insured state nonmember banks and their securities underwriting affiliates. Subpart C implements section 28 of the FDI Act, regarding the activities and investments of insured state savings associations. Subpart D implements section 18(m) of the FDI Act, which requires insured state savings associations to

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<sup>142</sup> See 12 CFR part 362.

file a notice with the FDIC before establishing a new subsidiary or engaging in a new activity in an existing subsidiary. Subpart E was added to part 362 in 2001 to implement section 46 of the FDI Act. It applies to insured state nonmember banks that wish to engage, as principal, through a financial subsidiary in financial activities, such as securities underwriting.<sup>143</sup>

## Notices, Applications, and Processing

The FDIC has a long history of reviewing filings submitted by state banks to engage in activities that are permissible under state law but have not been determined to be permissible for national banks. The FDIC's authority is derived from section 24 of the FDI Act as implemented through part 362 of the FDIC's regulations and the filing procedures in 12 CFR 303, subparts G (state banks) and H (state savings associations). Certain activities that the FDIC previously addressed under section 24 and subpart A of part 362, such as general securities underwriting, are now authorized for a financial subsidiary of a national bank and considered under section 46 (and subpart E of part 362), instead of section 24 of the FDI Act.

Other activities conducted as principal, such as real estate development or investment, may not be conducted by financial subsidiaries of national banks and are outside the scope of section 46(a). These activities continue to be governed by section 24 and subpart A of part 362. State banks that wish to engage in activities that are permissible under state law but that have not been deemed permissible for national banks may seek the FDIC's consent by filing a notice or application. State banks that previously obtained the FDIC's consent under section 24 to continue to engage in an activity that is considered a newly designated "financial activity" under section 46 are permitted to continue to engage in that activity pursuant to the requirements imposed under section 24.

Whether an institution must file a notice or an application depends on the nature and/or extent of the activity. With notices, the FDIC typically informs the institution of its non-objection or objection to the proposed activity within the prescribed time. The absence of a response from the FDIC within the applicable time after the submission of a complete notice is, in effect, a non-objection to the proposed activity or investment.<sup>144</sup> For activities for which an application is required, the failure of the FDIC to act prior to the expiration of the regulatory time does not constitute approval of the proposed activity or investment.<sup>145</sup> If the FDIC permits the activity, whether by approving an application or issuing its non-objection to a notice, the insured depository institution must continue to meet the notice requirements or any condition imposed by the FDIC.

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<sup>143</sup> "A financial subsidiary may engage solely in activities that national banks are permitted to engage in directly and are subject to the same terms and conditions that govern the conduct of such activities by national banks or a national bank is specifically authorized by the express terms of a Federal statute...and not by implication or interpretation, to control...". 12 USC 24a(g)(1).

<sup>144</sup> 12 CFR 303.122(a).

<sup>145</sup> 12 CFR 303.122(b).

Institutions that submit filings under part 362 must indicate whether they meet the criteria required for that specific type of activity or investment. During its review, the FDIC determines whether the activity also requires the submission of an application to the state banking authority. Upon receipt of a filing made pursuant to section 24, the FDIC must determine whether the request is for an activity or investment that has not been determined to be permissible for a national bank or its subsidiaries and, therefore, requires action under part 362. The FDIC must make a similar determination under section 28 pertaining to the permissibility of the activity for a federal savings association when a state savings association submits a filing under part 362, subpart C. In reviewing notices received from insured state savings associations pursuant to section 18(m), the FDIC must determine whether the new subsidiary or the proposed new activity of an existing subsidiary raises safety and soundness concerns.

State nonmember banks seeking to obtain control or hold an interest in a financial subsidiary pursuant to section 46 must file with the FDIC a self-certification notice pursuant to subpart E of part 362. The bank and its subsidiary must meet the section 46 requirements for a financial subsidiary as well as the regulatory standards contained in subpart E. The bank may commence the activity, or acquire a subsidiary already engaged in the activity, 30 days after the self-certification notice has been submitted to the FDIC (or earlier, if FDIC advises in writing), unless the notice period is extended.

For applications, the FDIC determines whether the submission is complete. Applications that are not substantially complete may be returned to the applicant with a letter outlining the deficiencies. If the applicant fails to provide the information in a reasonable time, the application may be deemed abandoned and returned to the applicant.

## **Part 362 Determinations and the Conditions Imposed on Part 362 Approvals**

Pursuant to section 620, the FDIC conducted a review of its determinations regarding filings made under part 362 and the conditions imposed on those approved applications. This section of the study provides a summary overview of the types of activities for which banks sought the FDIC's approval to engage under part 362 and the related risks related to those activities which were identified by the FDIC. This section also provides an overview of the FDIC's risk-mitigating conditions imposed in a sample of these applications.

Part 362 applies to activities of all insured state banks and insured state savings associations.<sup>146</sup> Thus, a small minority of the filings FDIC staff reviewed were submitted by state member banks. Additionally, part 362 subpart D applies to insured state savings associations and requires that a notice be filed by such an association before it acquires or establishes a new subsidiary or conducts new activities through an existing subsidiary.<sup>147</sup> From 2011 to 2013, the number of applications submitted by institutions supervised by the OCC surpassed the number of

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<sup>146</sup> See 12 CFR 362.

<sup>147</sup> See 12 CFR 362.15.

applications submitted by institutions supervised by the FDIC. This shift may be the result of title III of Dodd–Frank, which abolished the OTS and appointed the OCC as the appropriate federal banking agency for federal savings associations and the FDIC as the appropriate federal banking agency for state savings associations.<sup>148</sup>

A general point worth noting about these part 362 applications is that, in many cases, state banks were permitted to establish subsidiaries structured as limited liability companies (LLC) or limited partnerships (LP). In a number of instances, these LLCs or LPs were established to engage in activities that have been determined to be permissible for a national bank.<sup>149</sup>

In this regard, pursuant to an FDIC financial institution letter (FIL) published on November 19, 2014, a state bank that seeks to engage through an LLC or LP in an activity determined by the OCC to be permissible for a national bank, subject to the same conditions or restrictions imposed by the OCC, no longer needs to file an application or notice with the FDIC. The OCC generally permits a national bank to make investments in a subsidiary organized as an LLC, LP, or similar entity under certain conditions, including that the underlying activity in which the LLC or LP would engage is permissible for a national bank.<sup>150</sup> Thus, some of the applications FDIC staff previously reviewed would no longer require an application today. Most of the applications reviewed in this study that were associated with LLCs and LPs involved state banks that sought to indirectly engage in activities not determined to be permissible for a national bank; therefore, an insured state bank’s investment in these subsidiaries would continue to require application, despite the FDIC’s issuance of the 2014 FIL.

The FDIC has conditioned each of its part 362 approvals with specific conditions intended to mitigate the risks associated with a state bank’s direct or indirect investment or activity. The review identified 46 different conditions that the FDIC applied to its approvals, and most approvals were contingent on multiple conditions. Conditions frequently imposed on part 362 approvals include the requirement for the applicant to submit an additional application before

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<sup>148</sup> 12 USC 1813(q).

<sup>149</sup> When part 362 was issued in 1998, LLCs and LPs represented new organizational structures for business entities. Noting that there was little definitive legal guidance concerning the liability protection offered by these entities, the FDIC explained that it would examine these entities on a case-by-case basis and required a state bank to file an application with the FDIC when it sought approval of activities and investments using subsidiaries organized as LLCs and LPs. The FDIC indicated that it would revisit the issue at a later time. FDIC, “Activities of Insured State Banks and Insured Savings Associations,” 63 Fed. Reg. 66276, 66286 (December 1, 1998).

On November 19, 2014, the FDIC issued FIL 54-2014, “Filing and Documentation Procedures for State Banks Engaging, Directly or Indirectly, in Activities or Investments that Are Permissible for National Banks.” In that FIL, the FDIC eliminated the filing requirements for state banks that requested to conduct otherwise permissible activities using subsidiaries organized as LLCs or LPs. Instead, if a state bank seeks to use a subsidiary organized as an LLC or LP to conduct permissible activities or investments, it need only maintain documentation in its files that demonstrates (1) that the activity is permissible for a national bank or its subsidiaries and (2) that the LLC or LP satisfies the same organizational requirements that the OCC imposes on similar subsidiaries of national banks.

<sup>150</sup> See 12 CFR 5.34; FIL 54-2014, “[Filing and Documentation Procedures for State Banks Engaging, Directly or Indirectly, in Activities or Investments that are Permissible for National Banks](#)” (November 19, 2014).



making any changes related to the approved activity or investment, a requirement for the applicant to limit investments to those currently held or proposed to be held, requirements for the subsidiary engaging in the activity to develop policies and procedures independent from the bank, along with separate accounting and business records from the bank, and various capital requirements, among others.

In addition to specific risk-mitigating conditions imposed in conjunction with each approval, institutions for which activities and investments were approved under part 362 also are subject to the general prudential regulatory and supervisory framework employed by the FDIC and the other federal banking agencies.

Among other things, this regulatory framework includes recently enhanced capital standards that have a risk-mitigating impact on the investments and activities in which insured depository institutions may engage.<sup>151</sup>

This section of the study provides a review of the types of activities approved under part 362 and the related risks. This section also provides an overview of the risk-mitigating conditions imposed by the FDIC in conjunction with the approvals related to a sample set of filings, as well as other applicable guidance and rules that also have a risk-mitigating impact. Consistent with the requirements of section 620, this portion of the report is followed by a section addressing actions being considered by the FDIC relative to the investments and activities of insured state banks and savings associations to ensure that activities approved and undertaken pursuant to part 362 do not jeopardize the safety and soundness of those institutions.

## Real Estate

### *Real Estate Activities and Investments Approved Under Part 362*

Since the 1991 enactment of section 24 of the FDI Act, the FDIC has permitted insured state bank to engage in the following real estate activities and investments:

- A bank may indirectly, through a wholly owned subsidiary, develop residential-commercial real estate from the initial stage involving 2 percent of tier 1 capital or less.
- A bank may indirectly, through a wholly owned subsidiary, develop residential-commercial real estate from the initial stage involving over 2 percent of tier 1 capital.
- A bank may indirectly, through a wholly owned subsidiary, hold residential real estate involving 2 percent of tier 1 capital or less.
- A bank may indirectly, through a wholly owned subsidiary, hold residential-commercial real estate involving over 2 percent of tier 1 capital.
- A bank may indirectly, through a wholly owned subsidiary, hold residential-commercial real estate until liquidation.

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<sup>151</sup> See FDIC, “Regulatory Capital Rules,” 78 Fed. Reg. 55340 (September 10, 2013) (interim final rule) and 79 Fed. Reg. 20754 (April 14, 2014) (final rule), as codified in 12 CFR part 324.

- A bank may indirectly, through a wholly owned subsidiary, engage in the leasing of real property under certain circumstances involving 2 percent of tier 1 capital or less.
- A bank may indirectly, through a wholly owned subsidiary, engage in the leasing of real property under certain circumstances involving over 2 percent of tier 1 capital.
- A bank's majority owned subsidiary may invest in a limited partnership or limited liability company.
- A bank may indirectly, through a majority owned subsidiary organized as a limited liability company, engage in activities under section 24 of the FDI Act.
- A bank may indirectly, through a wholly owned subsidiary organized as a limited partnership, engage in activities under section 24 of the FDI Act.
- A bank may indirectly, through a wholly owned subsidiary, own real estate beyond the ten-year statutory limit.

A significant minority of real-estate related applications dealt with real estate originally held as a result of debts previously contracted (DPC). A majority of these DPC-related applications related in the establishment of wholly owned subsidiaries to hold and manage real estate (including other real estate owned (OREO)) acquired in connection with DPC, to engage in real estate development (commercial, residential, and bank premises) through these subsidiaries, and to transfer to and hold real estate in these subsidiaries that has been acquired in connection with DPC and had been held for a period that exceeded the length of time permitted under state or federal law.

While national banks are permitted to hold certain types of real estate, including real estate acquired in satisfaction of DPC, there are restrictions and requirements related to the holding period, disposition, appraisals, and additional expenditures and notifications related to such properties.<sup>152</sup> For example, a national bank generally is prohibited from possessing real estate acquired DPC for a period longer than five years. After that time, the bank may apply to, and the OCC may approve, the possession of such DPC property for a period longer than five years, but not to exceed an additional five years under certain conditions. In many instances, part 362 applicants sought to hold such real estate beyond the maximum ten-year period allowable by the OCC or the shorter period permitted under governing state law.<sup>153</sup> In the sample set, the FDIC granted approval for a state bank to engage in real estate sales through a wholly owned subsidiary, with the stipulation that the bank's indirect real estate investment activities were limited to those currently held, and that the bank was required to divest all interest in the real estate within ten years. The FDIC granted approval for a bank's wholly owned subsidiary to invest in an LP holding global real estate investments, and, separately, allowed for banks to invest in real estate ventures and venture partnerships through wholly owned subsidiaries.

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<sup>152</sup> See 12 USC 29, 12 CFR 34.82.

<sup>153</sup> 12 CFR 362.1(b)(3).

## *Risk Identification*

Real estate investment is subject to a high degree of market risk and other specialized risks specific to real estate ownership.<sup>154</sup> Often, unforeseen, unusual, localized, or adverse economic conditions may result in a temporary or permanent decline in realty values. In addition to these risks, the principal risks associated with real estate investments include inflation of the price structure because of inadequate regard to normal or depressed realty values during periods when it is in great demand, thus inflating the price structure, and failure to reasonably restrict investment in properties for which there is limited demand. Real estate development investments are vulnerable to a wide variety of risks. The major risk arises from the necessity to complete projects within specified cost and time limits.<sup>155</sup>

OREO consists of real property held for reasons other than to conduct bank business. Banks usually acquire OREO through foreclosure after a borrower defaults on a loan secured by real estate. Most states have laws governing the acquisition and retention of such assets.<sup>156</sup>

Financial institutions typically acquire OREO through foreclosure or deed in lieu of foreclosure after a borrower defaults on a loan. Holding OREO presents inherent risks, such as liquidity, operational, and compliance risks. While regulatory approval to extend the holding period of OREO continues such inherent risks, such approvals are typically limited in duration and do not expose financial institutions to any new risks. When considering the extension of applicable OREO holding periods, the FDIC considers the specific facts relevant to each request. Approvals of such requests generally provide financial institutions with additional time to realize the value of the property with the anticipation of reducing possible losses.

## *Risk Mitigation*<sup>157</sup>

The activities and investments approved by the FDIC are typically subject to various restrictions or conditions. The conditions most frequently associated with real estate-related approvals include, but are not limited to, the following:

- The approval is granted based on the facts stated in the application or order and no changes are permitted without further application or notice of the FDIC.

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<sup>154</sup> See FDIC, *Appeals of Material Supervisory Determinations: Guidelines & Decisions*, SARC-99-03.

<sup>155</sup> See FDIC, *DSC Risk Management Manual of Examination Policies* 3.2-15.

<sup>156</sup> See *supra* notes 29–31 and accompanying text; see also FDIC, *DSC Risk Management Manual of Examination Policies* 3.6-2.

<sup>157</sup> It should be noted that since the time any particular application was approved, key statutory or regulatory changes may have taken place, which might affect how the issues would be treated today. The risk mitigation section for each activity type details conditions, rules, and regulatory guidance, regardless of implementation date, that mitigate risks posed by activities and investments approved by the FDIC under part 362.

- The bank’s investments are limited to current holdings or may be increased only up to a specified amount.
- The bank and subsidiary must maintain separate business entity records and formalities, such as separate board of directors meetings.
- The subsidiary must conduct business pursuant to independent policies and procedures designed to inform customers that the subsidiary is a separate organization.
- The subsidiary meets applicable statutory or regulatory capital requirements and has sufficient operating capital in light of normal obligations that are reasonably foreseeable in a business of its size and character.
- Restrictions are imposed in accordance with sections 23A and 23B of the Federal Reserve Act (FRA).<sup>158</sup>
- The bank must be well capitalized after deducting the investment discussed in the application.
- Transactions with a majority-owned subsidiary must be on terms and conditions that are substantially the same as those prevailing at the time for comparable transactions with unaffiliated parties.
- The bank or subsidiary of a bank engaging in the activity must have qualified management and employees for the type of activity.
- The bank or subsidiary must divest or reduce holdings required within a specified period.
- The asset or activity must be transferred to a majority-owned subsidiary.
- The subsidiary engaging in the activity must have only one business type.
- The subsidiary must have a current written business plan appropriate to the type and scope of business conducted by the subsidiary.

*FDIC Financial Institution Letter: Guidance on OREO*<sup>159</sup>

The FDIC issued a FIL to address safety and soundness matters regarding OREO.<sup>160</sup> The FDIC encourages institutions to avoid unnecessary foreclosures of residential properties through loan modifications that achieve affordable, sustainable mortgage obligations. When foreclosures are unavoidable, the FIL reminds institutions of the need to establish policies and procedures for acquiring, holding, and disposing of OREO. These policies and procedures should ensure that:

- the institution’s interests in the OREO are protected, while mitigating the impact on the value of surrounding properties;
- OREO is accounted for in conformance with the Instructions for the Consolidated Reports of Condition and Income; and
- the institution complies with applicable federal and state laws and regulations pertaining to holding OREO.

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<sup>158</sup> 12 USC 371c and 371c-1.

<sup>159</sup> FIL 62-2008, “Guidance on Other Real Estate” (July 1, 2008).

<sup>160</sup> Id.

## Appendix A to Part 364 – Interagency Guidelines Establishing Standards for Safety and Soundness

The guidelines require institutions to establish and maintain a system that is commensurate with the institution's size, nature, and scope of its operations to identify problem assets and prevent deterioration in those assets, including taking appropriate corrective action to resolve problem assets.<sup>161</sup>

### Equity Securities

#### *Equity Security Investments Approved Under Part 362*

Since the 1991 enactment of section 24 of the FDI Act, the FDIC has permitted insured state bank to engage in the following equity investments:

- A bank may indirectly, through a wholly owned subsidiary, purchase the stock of a bank, bank holding company, savings association, or savings and loan holding company not listed on a national securities exchange and sell the same.
- A bank may indirectly, through a wholly owned subsidiary engage, in the trading of equity securities for its own account in stock listed on a national securities exchange.
- A bank may own adjustable rate preferred and money market preferred stock up to 100 percent of tier 1 capital.
- A bank may indirectly, through a wholly owned subsidiary, continue to hold subordinated debt or preferred stock and warrants or common stock of non-bank entities not listed on a national securities exchange and fund capital calls and exercise warrants.
- A bank may establish a financial subsidiary subject to the notice requirements of section 46 of the FDI Act.
- A bank's majority owned subsidiary may invest in an LP or LLC.
- A bank may indirectly, through a majority-owned subsidiary organized as an LLC or LP, engage in activities under section 24 of the FDI Act.

Based on a review by the FDIC of applications related to equity security investments, the most prevalent type of application related to the establishment of wholly owned subsidiaries structured as LLCs that would indirectly make equity investments. Some of these LLCs were established to conduct a variety of additional activities, including providing investment advice, managing OREO and other assets acquired from foreclosures, resolving a problem loan, engaging in securities underwriting, holding and managing condominium units, and engaging in mortgage banking and commercial lending, among others.<sup>162</sup> Banks were approved to make limited indirect investments through wholly owned subsidiaries in unlisted equity investments and publicly traded stocks, including the stock of other financial institutions.

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<sup>161</sup> See 12 CFR part 364, appendix A.

<sup>162</sup> Certain activities that the FDIC previously addressed under section 24 and Subpart A of Part 362, such as general securities underwriting, are now authorized for a financial subsidiary under section 46 of the FDI Act.

## *Risk Identification*

Equity investments in securities can create considerable risk exposures, particularly market risk, credit risk, liquidity risk, operating risk, legal risk, settlement risk, and interconnection risk. The following guidance summarizes the major risk exposures.

Market risk is the possibility that an instrument will lose value because of a change in the price of an underlying instrument, change in the value of an index of financial instruments, changes in various interest rates, or other factors. Frequently, an instrument will increase a bank's market risk because of price volatility, embedded options, leverage factors, or other structural factors. The three principal types of market risk are price risk, interest rate risk, and basis risk.

Price risk is the possibility that an instrument's price fluctuation will unfavorably affect income, capital, or risk reduction strategies. Price risk is usually influenced by other risks. For example, a bond's price risk could be a function of rising interest rates, while a currency-linked note's price risk could be a function of devaluation in the linked currency.

Interest rate risk is the possibility that an instrument's value will fluctuate in response to current or expected market interest rate changes. Yield curve risk is the possibility that an instrument's value will fluctuate in response to a nonparallel yield curve shift. Yield curve risk is a form of interest rate risk.

Basis risk is the possibility that an instrument's value will fluctuate at a rate that differs from the change in value of a related instrument. For example, the imperfect correlation between three-month Eurodollar and Treasury bill yields can create basis risk.

Credit risk is the possibility of loss due to the default of a counterparty or issuer or that party's inability to meet contractual payment terms. The amount of credit risk equals the replacement cost (also referred to as current exposure) of an identical instrument. The replacement cost is established by assessing the instrument's current market value rather than its value at inception. In addition, default exposes a bank to market risk. After default, losses on a now unhedged position may occur before the defaulted hedge instrument can be replaced. Such losses would have been largely (or completely) offset if the counterparty had not defaulted.

Liquidity risk is the possibility that an instrument cannot be obtained, closed out, or sold at (or very close to) its economic value. As individual markets evolve, their liquidity will gradually change, but market liquidity can also fluctuate rapidly during stress periods. In some markets, liquidity can vary materially during a single day. Some markets are liquid for particular maturities or volumes, but are illiquid for others. For example, the Eurodollar futures market is liquid for contracts with maturities up to four years, but liquidity decreases for greater maturities (although maturities of up to 10 years are listed). Many instruments trade in established secondary markets with a large number of participating counterparties. This ensures liquidity under normal market conditions. However, uniquely tailored or more thinly traded products may not have sufficient supply, demand, or willing counterparties in periods of market stress.

Operational risk is the possibility that inadequate internal controls or procedures, human error, system failure, or fraud can cause losses. Operational risk can result in unanticipated open positions or risk exposures that exceed established limits.

Legal risk is the possibility that legal action will preclude the contractual performance of a counterparty. Legal risk may occur when a contract or instrument violates laws or regulations. Legal risk may also occur when a law or regulation prohibits a counterparty from entering into a particular contract, or if an individual is not authorized to execute transactions on behalf of the counterparty.

Settlement risk is the possibility of loss from a counterparty that does not perform after the investor has delivered funds or assets (before receiving the contractual proceeds). Settlement risk may result from time differences between foreign counterparties, delivery that is not synchronized with payment, or method-of-payment delays. Few transactions are settled on a real-time basis, and any delay in receiving funds or assets after delivering funds or assets will create settlement risk.

Interconnection risk is the possibility of loss due to changes in interest rates, indices, or other instrument values that may or may not be held by the investor. Cash flows associated with an instrument may be directly or indirectly tied to a number of other rates, indices, or instrument values. These interconnections frequently involve cross-border and cross-market links and a wide range of individual financial instruments.<sup>163</sup>

### *Risk Mitigation*

The activities and investments approved by the FDIC typically are subject to various restrictions or conditions. The conditions most frequently imposed on approval related to investment in equity securities include, but are not limited to, the following:

- The asset or activity must be transferred to a majority-owned subsidiary.
- The bank's equity investments and other investments are limited to current holdings or may be increased only up to a specified amount.
- Insider transactions are restricted.
- The bank must be well capitalized after deducting the investment discussed in the application.
- The subsidiary must maintain separate business and accounting records from the bank.
- The subsidiary must meet applicable statutory or regulatory capital requirements and have sufficient operating capital in light of normal obligations that are reasonably foreseeable in a business of its size and character.
- Transactions with a majority-owned subsidiary must be on terms and conditions that are substantially the same as those prevailing at the time for comparable transactions with unaffiliated parties.

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<sup>163</sup> See FDIC, *DSC Risk Management Manual of Examination Policies* 3.3.

- The subsidiary must conduct business pursuant to independent policies and procedures designed to inform customers that the subsidiary is a separate organization.
- The subsidiary must observe separate business entity formalities such as board of directors meetings.
- The restrictions of sections 23A and 23B of the FRA are imposed.
- The subsidiary must have qualified management and employees for the type of activity.

### Examination Guidance

FDIC's *Risk Management Manual of Examination* provides guidance for evaluating the effectiveness of a bank's risk management program in identifying, measuring, monitoring, and controlling investment activity risks. Bank management is expected to establish a risk management program that identifies, measures, monitors, and controls investment activity risks commensurate with the bank's size, complexity, and investment activities. Thus, the program is expected to be tailored to the bank's needs and circumstances. The manual provides that an effective risk management program includes the following processes:

- The board should adopt policies that establish clear goals and risk limits.
- The board should review and act upon management's reports.
- The board should establish an independent review function and review its reports.
- Management should develop investment strategies to achieve the board's goals.
- Management should analyze and select investments consistent with its strategies.
- Management should maintain an effective internal control program.
- Management should regularly measure the portfolio's risk levels and performance.
- Management should provide periodic reports to the board, and
- The board and management should periodically evaluate and, when warranted, modify the program.<sup>164</sup>

### Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities

This policy statement provides guidance to financial institutions on sound practices for managing the risks of investment securities. The guidance states that institutions should have programs to manage the market, credit, liquidity, legal, operational, and other risks of investment securities.<sup>165</sup>

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<sup>164</sup> See FDIC, *DSC Risk Management Manual of Examination Policies* 3.3.

<sup>165</sup> FFIEC, "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities," 63 Fed. Reg. 20191 (May 26, 1998).



### *Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions*

This uniform agreement states that fundamental credit analysis should be applied to investment securities based on the security's risk characteristics, including its size, nature, and complexity.<sup>166</sup>

### *Enhanced Regulatory Capital Rules*

The agencies' regulatory capital rules contain certain capital deductions and heightened risk weights for equity investments and investments in the capital instruments of other financial institutions.

### *The Volcker Rule*

The Volcker Rule places prohibitions and restrictions on the ability of bank holding companies, insured depository institutions, and their subsidiaries and affiliates to engage in proprietary trading or to invest in, or have relationships with, hedge funds and private equity funds. For more information, see "Securities—Risk mitigation—Volcker Rule" in the OCC's section of this report.

## **Mineral Rights**

### *Mineral Rights Activities and Investments Approved under Part 362*

In almost all states, interests in mineral rights are considered interests in real estate. For purposes of this study, activities and investments involving mineral rights are considered apart from other real estate investment or development activities. Since the 1991 enactment of section 24 of the FDI Act, the FDIC has permitted insured state banks to engage in the following activities related to mineral interests:

- In certain circumstances, a bank may indirectly, generally through a properly insulated subsidiary, engage in activities or investments related to mineral interests.
- A bank may, indirectly through a wholly owned subsidiary, own real estate beyond the ten-year statutory limit.

A majority of the mineral rights-related approvals in the review sample were related to requests to engage in, or continue to engage in, an activity associated with mineral rights that were connected to or severed from real estate acquired in connection with DPC. The majority of DPC-related approvals for this category were related to the establishment of wholly owned subsidiaries to hold and manage the mineral rights connected to or severed from real estate acquired in connection with DPC. Several banks have severed, or plan to sever, the mineral

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<sup>166</sup> See OCC, Board, and FDIC, [\*Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions\*](#) (October 29, 2013).

rights from the surface real estate rights, foreclose on the surface properties, and retain only the mineral rights.

In some cases, these mineral rights are subject to an oil and gas lease when the property is acquired DPC; in other instances, the bank desires to enter into active oil and gas leases or mineral leases involving possible oil and gas exploration. In other cases, the banks assert that their subsidiaries passively will own the mineral interests or will receive royalty income as a mineral owner, but will not engage in oil or gas exploration or production. State banks have submitted applications to engage in other non-traditional real estate related activities involving requests to harvest timber, hunt, and fish on real estate originally acquired in connection with DPC.

Part 362, by its terms, does not apply to equity investments acquired in connection with DPC if the bank does not hold the property for “speculation” or take actions that are not permissible for a national bank.<sup>167</sup> Equity investments include any ownership in real estate, which encompasses oil and gas interests in states where oil and gas interests are considered real property. During the initial DPC period, if a bank (either directly or through its subsidiary) seeks to convert its passively held mineral interest to one involving more active use of the interest, it must file an application. The FDIC considers “active use” of a mineral interest to include production, extraction, or exploration activities (initial or expansion of existing), or entering into a lease involving mineral interests. Equity investments acquired in connection with DPC must be disposed of within the shorter of the period set by federal law for national banks or the period allowed under state law.<sup>168</sup> Under the National Bank Act, the allowed holding period for real estate-acquired DPC is limited to 10 years.<sup>169</sup> After the shorter of the federal 10-year holding period or the governing period permitted by state law, a state bank may hold real property through a qualified subsidiary if a related notice or application is filed with and approved by the FDIC. If the oil and gas interest is considered real property under state law, and the bank intends to engage in active or speculative use of the oil and gas interest, an application is required. If a severed oil and gas interest is considered personal property under state law, and the bank intends to hold the interest either directly or through a qualified subsidiary, an application is required.

### *Risk Identification*

The risks associated with holding mineral rights interests may increase as a bank becomes more involved in actual oil or gas production activities, thereby exposing itself to potential liability under general common law, environmental law, and specific oil and gas production law. Generally, a bank becomes involved in oil and gas production by leasing its mineral interests to

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<sup>167</sup> 12 CFR 362.1(b)(3).

<sup>168</sup> Id.

<sup>169</sup> 12 USC 29 allows national banks to hold real estate (real property) for an initial five-year period and an additional holding period of five years with approval of the OCC. A 1982 amendment to section 29 permits national banks holding real estate (including any subsurface rights or oil or gas interests) on October 15, 1982, to hold real estate for a longer time if permitted by state law.

an oil and gas producer. Potential loss exposure or liability for the bank may exist, in ways that are highly dependent on specific facts and circumstances and are unpredictable.

### *Risk Mitigation*

The conditions most frequently imposed on subsidiaries of banks seeking approval for various activities and investments related to mineral interests, include, but are not limited to, the following:

- The subsidiary must be physically separate and distinct in its operations from its parent bank (in degrees that may vary according to the nature of customer contacts).
- The subsidiary must maintain separate accounting and business records.
- The subsidiary must observe separate business formalities, such as board of directors' meetings.
- The subsidiary must have a chief executive officer who is not a bank employee.
- The subsidiary must have a majority of its directors and officers independent of bank management.
- The subsidiary must conduct business pursuant to independent policies and procedures designed to inform the public that the subsidiary is distinct from the bank.
- The subsidiary must have a single business purpose consistent with FDIC regulations.
- The subsidiary must have a written business plan appropriate to the business conducted.
- The subsidiary must have well-qualified and appropriately licensed management and employees.
- The subsidiary must have policies and procedures that provide adequate controls and structure for the implementation of the business.

Depending on the nature of its mineral rights interest holdings, the manner in which they were acquired, and the likelihood of potential risk, an insured state bank may insulate itself from potential liability, including environmental liability, in a number of ways including use of a properly insulated subsidiary. The FDIC's regulations reflect the importance of corporate separateness between a state-chartered depository institution and its subsidiaries. It should be noted that if the subsidiary and the bank fail to maintain corporate separateness, the bank might be liable for damages caused by the activities of its subsidiary.

In some cases, the lease agreement itself can be used by a bank to mitigate the liability risk presented by oil and gas exploration and activities. Beneficial lease terms could include indemnification clauses, requirements for insurance and for the lessee to remain in good standing with relevant regulators, and other controls. In other cases, for example if a state-chartered insured depository institution acquires an interest in a previously negotiated mineral rights lease, it may not be feasible to incorporate the suggested provisions into the contractual agreement that governs a given transaction. If the lease terms cannot be negotiated, risk-mitigating steps could include investigation of the potential risk impacts of the specific oil and gas activities, of the current and future business practices of the operator, and seeking protection for potential damages through a separate indemnification agreement, insurance policy, or bond, as appropriate.

## *Guidelines for an Environmental Risk Program*

In 2006, the FDIC issued updated “Guidelines for an Environmental Risk Program,”<sup>170</sup> which states in part that institutions should maintain an environmental risk program in order to evaluate the potential adverse effect of environmental contamination on the value of real property and the potential environmental liability associated with the real property. As part of the institution’s overall decision-making process, the environmental risk program should establish procedures for identifying and evaluating potential environmental concerns associated with lending practices and other actions relating to real property.

## **Insurance**

### *Insurance Activities Approved Under Part 362*

Since the 1991 enactment of section 24 of the FDI Act, the FDIC has considered only a few applications related to insurance activities or investments. In response to these applications, the FDIC has permitted insured state banks to engage in the following activities and investments related to insurance:

- maintain life insurance policies on bank directors, officers, and employees.
- continue to hold an annuity issued by an insurance company.
- conduct specified insurance activities through wholly owned subsidiaries or service corporations.

### *Risk Identification*

Insurance companies are generally subject to interest rate risk, given their investments in fixed income assets; however, the life insurance sector is particularly sensitive to interest rate risk, as a result of its investment in longer-duration fixed income assets, which are typically held to maturity in order to match their long-tail liabilities. Particular insurance products are more sensitive to interest rate risk, such as whole life, fixed annuities, and products with explicit guaranteed terms. A protracted low-interest-rate environment may stress profits of insurers, especially life insurers, as the spread from the excess of the investment yield earned over the rate offered to policyholders compresses.

Bank ownership of life insurance policies presents several risks due to the long-term nature of the asset. In 2004, the federal banking agencies issued an “Interagency Statement on the Purchase and Risk Management of Life Insurance,” which describes these risks and the comprehensive risk management processes institutions should have for purchasing and holding bank-owned life insurance (BOLI).<sup>171</sup> While BOLI has been determined to be a permissible

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<sup>170</sup> FIL 98-2006, “[Environmental Liability—Updated Guidelines for an Environmental Risk Program](#)” (November 13, 2006).

<sup>171</sup> See FIL 127-2004, “[Interagency Statement on the Purchase and Risk Management of Life Insurance](#)” (December 7, 2004).

activity for national banks and federal savings associations if conducted in accordance with the interagency statement (and, therefore, would not require an application under part 362), the liquidity, transaction, operational, legal (tax and compliance), reputation, credit, interest rate, and price risks described in the interagency statement would be germane to applicants seeking to purchase and hold BOLI in a manner inconsistent with the interagency statement, but permissible under state law.

### *Risk Mitigation*

The insurance-related activities and investments approved by the FDIC are typically subject to various restrictions or conditions. The conditions most frequently imposed on insurance-related approvals include the following:

- The bank must ensure the subsidiary engaging in reinsurance provides access to information and records concerning its operations and transactions and provide the information and records to the FDIC.
- If local law impedes the bank's ability to obtain or provide information to the FDIC, the bank or subsidiary engaging in reinsurance must cooperate with the FDIC to obtain third-party waivers or consents to access information and records.
- The bank must ensure consent provisions are included in documents or instruments governing the subsidiary's customer relationships to permit disclosure to the FDIC of documents or information concerning customer relationships or accounts.
- Other relevant federal and foreign authorities must approve.
- The bank must ensure the subsidiary engaging in reinsurance develops and maintains a program designed to identify customers, sources of funds, and normal or expected transactions; monitor account activity for inconsistent transactions; and report suspicious activity in accordance with FDIC regulations.
- If the investment has not occurred within 12 months, then the FDIC's consent expires, unless the FDIC approves an extension of time.
- The bank will neither acquire any additional life insurance policies of a type that has not been determined to be permissible for a national bank nor modify the terms and conditions of the existing insurance policies, except to redeem them, without first obtaining the FDIC's prior written approval.

### *Interagency Statement on the Purchase and Risk Management of Life Insurance*<sup>172</sup>

The interagency statement provides, “the FDIC will not grant permission to make life insurance purchases if the FDIC determines that doing so would present a significant risk to the Deposit Insurance Fund or that engaging in such purchases is inconsistent with the purposes of Federal deposit insurance.” The statement establishes supervisory expectations for the purchase and management of BOLI that include effective senior management and board oversight; comprehensive policies and procedures, including appropriate limits; a thorough pre-purchase

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<sup>172</sup> Id.

analysis of BOLI products; and an effective ongoing system of risk assessment, management, monitoring, and internal control processes, including appropriate internal audit and compliance frameworks. As noted previously, the interagency statement addresses various risks of such investments and mitigating actions institutions should perform.

## Other Activities and Investments

### *Other Activities and Investments Approved Under Part 362*

Since the 1991 enactment of section 24 of the FDI Act, the FDIC has permitted insured state bank to engage in the following miscellaneous activities and investments:

- A bank may continue to guarantee a third party's loan.
- Under certain circumstances, a bank may engage in leasing activities.
- A bank may, in certain circumstances, through a wholly owned subsidiary, engage in securities underwriting.
- A bank may invest in money market preferred stock and adjustable rate preferred stock (ARPS) in an amount greater than 15 percent of tier 1 capital.

The FDIC also considered and approved the following activities:

- *Money market and adjustable rate preferred stock.* There were several requests for approval to increase investment limits in money market and adjustable rate preferred stock from 15 percent of total capital to 100 percent (though depending on the application and the state, these percentages varied). There was at least one approval for a bank to continue holding its existing auction rate securities that amounted to 50 percent of tier 1 capital until the auction market recovers and the securities can be sold or otherwise disposed of.
- *Auto rentals and short-term leases.* One bank was approved to continue to engage in an auto rental business through its wholly owned subsidiary. This was ultimately a request to continue to exceed certain limits regarding financial leasing and incidental activities such as short-term vehicle rental activity.
- *Synthetic leasing assets.* One bank was approved to receive transfer of synthetic leasing assets from a non-bank affiliate. These assets appear as leases, but behave like mortgage loans to the advantage of the lessee (with regard to book accounting and ownership) and lessor (with regards to tax, bankruptcy, and commercial law).
- *Securities underwriting.* There were two approvals to hold interests in financial subsidiaries that will engage in various activities as principal, including securities underwriting.<sup>173</sup>

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<sup>173</sup> Certain activities that the FDIC previously addressed under section 24 and subpart A of part 362, such as general securities underwriting, are now authorized for a financial subsidiary of a national bank.

### *Risk Identification: Money Market and Adjustable Rate Preferred Stock*

The FDIC has determined that a state bank's investment of up to 15 percent of the bank's tier 1 capital in ARPS or money market (auction rate) preferred stock does not represent a significant risk to the Deposit Insurance Fund.<sup>174</sup> A state bank may conduct this activity without first obtaining the FDIC's consent, provided that the bank meets and continues to meet the applicable capital standards as prescribed by the appropriate federal banking agency. Several of the approvals granted under part 362 allowed for institutions to invest up to 100 percent of the bank's tier 1 capital in these instruments.

Money market and adjustable rate preferred stock are preferred stock instruments where the dividend is reset on a regular basis, often through an auction. One risk in the ARPS market is concentration risk, derived from the limited number of issuers, the concentration of those issuers in certain industries, and the risk of downgraded ratings. A second risk factor is liquidity and price risk due to the lack of depth of the primary and secondary markets for ARPS. The ARPS market has faced challenges in recent years, primarily because the floating-rate dividend often fails to compensate for credit risk concerns about issuers and concentration risks.

Auction-rate securities (ARS) are long-term debt instruments typically sold by municipalities, by closed-end mutual funds such as ARPS, and by special purpose entities and others. ARS are debt instruments whose interest rates are reset periodically through auctions. A majority of such auctions have failed since mid-February of 2008 and the ARS market has collapsed. Prior to the financial crisis, the ARS market was considered stable, safe, liquid, and lucrative. Despite various settlements and repayment efforts, many investors are still fighting for the return of their money.<sup>175</sup>

### *Risk Identification: Auto Rentals and Short-term Leasing*

From a supervisory perspective, the risks associated with lease financing in general include credit, interest rate, liquidity, operational, price, compliance, and strategic risks. Short-term vehicle rental activities carry risks specific to the nature of this business. One of the primary risks is undue concentrations in investment in rental vehicles. Other risks in the short-term vehicle rental activities include bodily injury and property damage liability, physical damage to the rental cars, and general liability for facility, office areas, parking areas, outside storage facilities and land. Additionally, the car rental industry is subject to cyclical and seasonal fluctuations and is sensitive to interest rate changes and inflation.

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<sup>174</sup> See 12 CFR 362.3(b)(2)(iii).

<sup>175</sup> See Song Han and Dan Li, "Liquidity Crisis, Runs, and Security Design: Lessons from the Collapse of the Municipal Auction Rate Bond Market," *Proceedings of the Federal Reserve Bank of San Francisco* (January 2009).

### *Risk Identification: Synthetic Leasing Assets*

Synthetic leasing assets are described as financing transactions, documented primarily by a lease, which are treated as leases for accounting purposes but treated as financing for tax, bankruptcy, and commercial law purposes. Such leases are beneficial to lessees as they allow the lessee to be treated as the owner of the property for some purposes and not for others, which results in the property not being booked on the lessee's balance sheet and no debt being recorded in connection with the property on the lessee's books. This type of activity is considered similar to commercial lending, and the primary risk posed to the bank by the activity would, therefore, be credit risk. Additional risk exposure would be posed to the bank as legal owner of the property, and the bank may also be exposed to environmental liability by the synthetic leasing transactions.

### *Risk Identification: Securities Underwriting*

Underwriters assume responsibility for structuring and marketing securities and therefore bear some of the initial market risk of ownership associated with the transactions. There can be considerable uncertainty about the success or failure of new securities offerings, which results in the risk that the underwriter may not be able to sell the securities at a profit. In cases where the bank must sell the securities at a price below what it paid to purchase them from the issuer, the bank would suffer a loss of its own capital.<sup>176</sup> The type of security being underwritten as well as the structure of the offering influence the risks present in securities underwriting activities. Responsibilities of the underwriter can include designing the composition of tranches and the size and type of credit and liquidity enhancements based on the characteristics of the collateral and market conditions. There can be a significant element of legal and regulatory risk associated with securities underwriting.

### *Risk Mitigation: Other Activities and Investments*

The "other" activities and investments approved by the FDIC are typically subject to various restrictions or conditions, specific to the proposed activity or investment. The FDIC imposes conditions in its approval of applications categorized as "Other" similar to those discussed in the previous sections; however, these conditions will not be specifically discussed because of the varied nature of the activities and the number of different conditions imposed to address those risks.

### *Risk Mitigation: Money Market and Adjustable Rate Preferred Stock*

Risk mitigation in connection with part 362 approvals related to holdings of money market and adjustable rate preferred stock has primarily been through limits relative to tier 1 capital and through normal supervisory expectations for prudent risk management of investments. Banks in their role as investors also benefit from the broad framework of market regulation by federal agencies and self-regulatory organizations.

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<sup>176</sup> See Federal Reserve Bank of San Francisco, "[Why do investment banks syndicate a new securities issue \(and related questions\)?](#)" (December 1, 1999).



### *Risk Mitigation: Auto Rental and Short-term Leasing*

In approving bank applications to engage in temporary or short-term vehicle rentals, the FDIC imposed a number of conditions and corporate structural requirements on the institutions. The risk-mitigating conditions imposed by the FDIC include the following:

- The bank shall take the necessary actions to establish, and maintain the operations of the subsidiary as a separate corporate subsidiary which:
  - is adequately capitalized.
  - is physically separate and distinct in its operations from the operations of the bank.
  - maintains separate accounting and other corporate records.
  - observes separate formalities such as board of directors' meetings.
  - maintains separate employees who are compensated by the subsidiary.
  - conducts business pursuant to separate policies and procedures designed to inform customers and prospective customers of the subsidiary that it is a separate organization from the bank.
- The subsidiary maintains at least one outside director on the board of directors.
- Transactions between the bank and subsidiary shall be made in accordance with the restrictions of sections 23A and 23B of the FRA, to the same extent as though the subsidiary were an affiliate as defined therein, except that extensions of credit from the bank to the subsidiary to fund the subsidiary's leasing operations will not be considered to be covered transactions.
- Transactions involving the subsidiary and insiders of the bank must be made on the same terms and basis as transactions with non-insiders.
- The subsidiary's investment, net of depreciation, in rental vehicles shall be limited to the lesser of 5 percent of the subsidiary's assets or 10 percent of tier 1 capital, on a bank-only basis before inclusion of the bank's investment in the subsidiary by a certain date, and thereafter.

### *Risk Mitigation: Synthetic Leasing Assets*

Engaging in synthetic leasing would expose the bank to additional risk as legal owner of the property; however, lease transactions would be structured in a fashion that would substantially mitigate those risks. The bank would also be exposed to environmental liability by the synthetic leasing transactions; however, the presence of the indemnification and pre-purchase environmental audit could be expected to reduce whatever risk may be present. Protections would be afforded to the bank as a result of the manner in which the leases are structured, including the indemnification that would be provided by the lessees to the bank and the loss protections afforded the bank. Lastly, there would be sufficient insurance policies in place to mitigate the risk of liability to the bank as titleholder to the real property.

## *Risk Mitigation: Securities Underwriting*<sup>177</sup>

The FDIC's regulations at 12 CFR 362.8 provide certain restrictions on the activities of insured state banks that are affiliated with certain securities companies, including the following:

An insured state nonmember bank is prohibited from becoming or remaining affiliated with any securities underwriting affiliate company that directly engages in the public sale, distribution, or underwriting of stocks, bonds, debentures, notes, or other securities activity, of a type not permissible for a national bank directly, unless the company is controlled by an entity that is supervised by a federal banking agency or the state nonmember bank submits an application in compliance with 12 CFR 303.121 and the FDIC grants its consent under the procedures in 12 CFR 303.122(b), or the state nonmember bank and the securities underwriting affiliate company comply with the following requirements:

- (1) The securities business of the affiliate is physically separate and distinct in its operations from the operations of the bank, provided that this requirement shall not be construed to prohibit the bank and its affiliate from sharing the same facility if the area where the affiliate conducts retail sales activity with the public is physically distinct from the routine deposit-taking area of the bank;
- (2) The affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and the state-chartered depository institution is not responsible for and does not guarantee the obligations of the affiliate;
- (3) The bank adopts policies and procedures, including appropriate limits on exposure, to govern its participation in financing transactions underwritten by an underwriting affiliate;
- (4) The bank does not express an opinion on the value or the advisability of the purchase or sale of securities underwritten or dealt in by an affiliate unless it notifies the customer that the entity underwriting, making a market, distributing or dealing in the securities is an affiliate of the bank; and
- (5) The bank complies with the investment and transaction limitations in sections 23A and 23B of the FRA with respect to the affiliate.<sup>178</sup>

The final Volcker Rule includes exemptions for underwriting activities.<sup>179</sup> Banking entities are permitted to engage in underwriting activities subject to appropriate conditions including that a banking entity act as an underwriter for a distribution of securities and that the trading desk's underwriting position be related to that distribution. Also consistent with section 619 of Dodd–

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<sup>177</sup> Certain activities that the FDIC previously addressed under section 24 and subpart A of part 362, such as general securities underwriting, are now authorized for a financial subsidiary by section 46 of the FDI Act.

<sup>178</sup> 12 CFR 362.8(b).

<sup>179</sup> The FDIC's final rule implementing the Volcker Rule is codified at 12 CFR 351.

Frank is the regulatory condition that the underwriting position must not exceed the reasonably expected near-term demands of customers.<sup>180</sup>

## Recommendations

After a comprehensive review of the activities and investments in which state banks and state savings associations may engage, the FDIC has identified potential for enhancement, reconsideration, and clarification in several areas of the part 362 policy and procedures. Specifically, the FDIC plans to:

- review activities related to investments in other financial institutions and other equity investments to evaluate the interaction of existing FDIC regulations and supervisory approvals and conditions under part 362, with other more recent regulatory and statutory rules governing such investments, in order to determine whether changes to part 362 or related procedures with regard to such investments are needed.
- determine whether the prudential conditions and standards under which the FDIC will evaluate part 362 filings with respect to mineral rights, commodities, or other non-traditional activities need to be clarified and, if so, consider issuing a statement of policy pursuant to such review.

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<sup>180</sup> See 12 CFR 351.4, 12 CFR 351.5, and 12 CFR 351.6 for the conditions in the final rule related to the market making, underwriting, risk mitigating hedging, and other permitted proprietary trading activities, respectively.

## Section III: OCC

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This section of the report pertains to the activities of national banks, federal savings associations, and federal branches and agencies of foreign banks (federal banking entities), which are the banking entities supervised by the OCC.<sup>181</sup>

The OCC charters, regulates, and supervises national banks and federal savings associations and licenses and supervises the federal branches and agencies of foreign banks. The OCC's mission is to ensure that these institutions operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations.

Headquartered in Washington, D.C., the OCC has 63 office locations, including four district offices and an office in London that supervises the international activities of national banks. The OCC's nationwide staff of bank examiners conducts on-site reviews of federal banking entities and provides sustained supervision of these institutions' operations. OCC examiners analyze asset quality, capital adequacy, earnings, liquidity, and sensitivity to market risk, as well as Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance for all federal banking entities, and examiners assess compliance with federal consumer financial laws by federal banking entities with less than \$10 billion in assets. Examiners also evaluate management's ability to identify and control risk and assess federal banking entities' performance in meeting the credit needs of the communities in which they operate, pursuant to the CRA.

In supervising federal banking entities, the OCC has the authority to

- examine federal banking entities.
- approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure.
- take supervisory and enforcement actions against federal banking entities that do not comply with laws and regulations or that otherwise engage in unsafe or unsound practices.
- issue rules and regulations, legal interpretations, supervisory guidance, and corporate decisions governing investments, lending, and other practices.

The OCC employs a risk-based supervisory approach focused on evaluating risk, identifying material and emerging problems, and ensuring that individual federal banking entities take corrective action before problems compromise their safety and soundness. The OCC has specifically customized its supervisory programs into three distinct portfolios to reflect varying levels of complexity and risk among the institutions it oversees—community federal banking entities, midsize federal banking entities, and large federal banking entities (including federal

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<sup>181</sup> For purposes of this report, the OCC uses the term “federal banking entity” to refer to national banks, federal savings associations, and federal branches and agencies on a collective basis. To the extent any provision of this report is unique to one of these types of legal entities, the OCC uses the specific term, e.g., “national bank” or “federal savings association.”

branches and agencies of foreign banks). Within this context, the OCC further tailors the application of its supervisory standards and expectations to the size and complexity of each individual institution. In some areas, such as capital standards, the OCC sets explicit regulatory minimums that apply to all federal banking entities. The OCC then augments these minimums with additional requirements for the largest federal banking entities that reflect the complexity and risk of their operations and their interconnections with the broader financial market. In other areas, such as corporate governance, while the OCC's approach is more qualitative, the agency has heightened expectations for larger federal banking entities and applies heightened standards as the complexity, risk, and scale of operations increase. The OCC believes this flexibility to tailor supervisory and regulatory requirements to reflect the agency's assessment of the risk of individual federal banking entities promotes an effective and efficient supervisory regime while minimizing undue burden.

## Introduction

After a thorough and comprehensive review of information gathered through its supervision program, the OCC determined that the following activities and investments warranted special focus:

- Derivatives
- Physical commodities
- Securities
- Structured products

Based on its review of the information, its supervisory experience, and its experience implementing Dodd–Frank, the OCC is not recommending legislative action. The OCC, however, identified four potential enhancements to the prudential regulatory scheme and certain precedents that merit reconsideration or clarification. Specifically, the OCC plans to

- issue a proposed rule that restricts national banks from holding as Type III securities asset-backed securities, which may be backed by bank-impermissible assets, 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.
- clarify minimum prudential standards for certain national bank swap dealing activities.
- consider providing guidance on clearinghouse memberships.
- clarify regulatory limits on physical hedging.<sup>182</sup>
- address national banks' authority to hold and trade copper.
- incorporate the Volcker Rule into the OCC's investment securities rules.

The OCC is concerned with federal banking entities' investments in asset-backed securities backed by bank-impermissible assets. The credit quality of asset-backed securities depends heavily on the underlying assets, the cash flow rules, and the structure of the security itself.

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<sup>182</sup> The OCC implemented this recommendation before publishing this report. See OCC Bulletin 2015-35, "Quantitative Limits on Physical Commodity Transactions" (August 4, 2015).

Accordingly, it may be appropriate to determine permissibility by reference to the underlying assets, as is the case with Type V securities. This approach would prevent federal banking entities from investing in structures that hold bank-impermissible assets using their authority to purchase investment securities. Investing in asset-backed securities issued or guaranteed by government-sponsored enterprises (GSE) would remain permissible because the National Bank Act and HOLA specifically allow these investments. Because these changes will require amending 12 CFR 1 and 12 CFR 160, the OCC will propose them through its standard rulemaking process, beginning with a notice of proposed rulemaking. The OCC will consider public comments in deciding how to proceed and publish any amendments to its rules.

The OCC also has 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 assumptions. These “mark-to-model” assets and liabilities have no independent, external pricing and their value cannot be definitively established. Federal banking entities with concentrations of mark-to-model assets or liabilities raise supervisory concerns because the subjectivity inherent in valuing mark-to-model positions makes it difficult to assess a federal banking entity’s true risk profile and consequently its capital adequacy. As described in more detail below, the OCC proposes to address these concerns through rulemaking or guidance.

The OCC plans to clarify minimum prudential standards for national banks that engage in certain swap dealing activities. For example, some smaller national banks offer commodity derivatives to mid-market businesses in the energy and agriculture sectors; these national banks often do not have to register as swap dealers. The OCC is committed to ensuring that national banks conduct derivative activities safely, soundly, and in compliance with law. Accordingly, the OCC plans to clarify the minimum prudential standards for certain swap dealing activities.

The OCC is reviewing the risks that membership in certain clearinghouses poses to federal banking entity members. The OCC will consider issuing guidance on membership in these clearinghouses.

In addition, the OCC plans to clarify certain interpretive letters dealing with physical commodities. It plans to clarify and strengthen its limits on national banks’ physical hedges of customer-driven derivatives. Specifically, the OCC will provide a more prescriptive methodology for calculating those limits to assure that physical hedging activities promote safety and soundness. The OCC also plans to address national banks’ authority to hold and trade copper.

Finally, the OCC will update its investment securities regulations to harmonize them with the Volcker Rule. For example, the OCC will delete provisions that allow federal banking entities to invest in entities that are covered funds under the Volcker Rule.

## **Focus of this Section**

This section of the joint report focuses on the following activities and investments by federal banking entities (banking entities supervised by the OCC):

- Derivatives
- Physical commodities
- Securities
- Structured products

## Structure of this Section

This section discusses federal banking entities’ activities and investments as follows:

- Overview of legal authority for the activity or investment.<sup>183</sup>
- Identification of the chief risks associated with the activity or investment.
- Legislative and regulatory developments and other agency actions that mitigate these risks.
- Recommendations for further regulatory development, as appropriate.

The OCC’s recommendations in this report are based on an in-depth supervisory review of the activities of federal banking entities of different sizes.

## Derivatives

### Legal Authority

#### *Investment*

National banks may engage in derivative transactions with payments based on bank-permissible holdings. For example, to manage its investment portfolio, a national bank may use derivatives tied to interest rates, foreign exchange and currency, credit, precious metals, and investment securities.<sup>184</sup> Congress has recognized this activity in various statutes.<sup>185</sup>

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<sup>183</sup> The report discusses the legal authorities separately for national banks and federal savings associations because different statutes and rules apply to them. (Federal branches and agencies of foreign banks have the same powers as national banks. See 12 USC 3102(b).) The absence of precedent on point does not imply that a federal banking entity may or may not engage in a certain activity, only that the OCC, its predecessors, and courts have not ruled on the specific question. In general, there is less precedent on the powers of federal savings associations than those of national banks.

<sup>184</sup> OCC interpretive letters (IL) 1064, 1047, 693, 414, 260; OCC No Objection Letter 86-13; *Comptroller’s Handbook*, “Interest Rate Risk,” at 2 (1997); OCC Bulletin 1996-43, “Credit Derivatives: Guidelines for National Banks” (August 12, 1996).

<sup>185</sup> See, e.g., 12 USC 84 (incorporating credit exposure from derivatives into the legal lending limit); GLBA section 206(a)(6) (defining “identified banking product” to include any swap agreement except an equity swap with a retail customer).

## *Hedging*

Hedging the risks associated with bank-permissible activities is an integral part of those activities.<sup>186</sup> Risks common to banking include interest rate risk, currency risk, credit risk, and market risk. National banks may use derivatives to manage those risks.<sup>187</sup> A national bank may centrally manage risks arising from derivatives transactions of affiliates if the derivatives are permissible for the bank.<sup>188</sup>

Federal savings associations may engage in financial derivatives if authorized to invest in the underlying assets. In general, these transactions should reduce risk exposure.<sup>189</sup>

## *Dealing*

National banks may deal in derivatives that reference rates or assets permissible for bank investment.<sup>190</sup> With prior written OCC supervisory non-objection, a national bank may deal in derivatives on other rates and assets as part of a customer-driven<sup>191</sup> financial intermediation business.<sup>192</sup> The OCC has emphasized repeatedly that a national bank may not conduct a proprietary trading business in these derivatives.<sup>193</sup> The OCC has established a non-objection process for review of these activities by the examiner-in-charge (EIC).<sup>194</sup> Under this process, a national bank must demonstrate satisfactory risk measurement and management processes to its EIC.<sup>195</sup>

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<sup>186</sup> OCC IL 896.

<sup>187</sup> E.g., OCC Bulletin 1996-43, “Credit Derivatives: Guidelines for National Banks” (August 12, 1996) (hedging credit risk); OCC Banking Circular 79 (3rd rev.), “National Bank Participation in the Financial Futures and Forward Placement Markets” (April 19, 1983) (hedging interest rate risk).

<sup>188</sup> OCC IL 1018.

<sup>189</sup> 12 CFR 163.172.

<sup>190</sup> E.g., OCC IL 494, 422.

<sup>191</sup> A “customer-driven” transaction is one entered into for a customer’s valid and independent business purposes. See OCC IL 892.

<sup>192</sup> OCC No-Objection Letter 87-5.

<sup>193</sup> E.g., OCC IL 1073, 1065, 1064, 1060, 1025, 1018, 962, 949, 937.

<sup>194</sup> See, e.g., OCC IL 937; *Comptroller’s Handbook*, “Risk Management of Financial Derivatives” (February 1998).

<sup>195</sup> An effective risk measurement and risk management process includes board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems. The bank must have an independent compliance monitoring program to ensure, among other things, that the derivatives dealing is a customer-driven and non-proprietary trading business.



## *Other Activities*

National banks may be members of securities and commodity exchanges and clearinghouses. Exchange or clearinghouse rules may require members to assume liability for other members' defaults. A national bank may assume this liability if

- the bank establishes a comprehensive risk management framework to control its exposure,<sup>196</sup> and
- the bank has adequate risk management systems and controls to estimate and limit its potential liability exposure.<sup>197</sup>

Federal savings associations may be clearing members of securities exchanges that allow members to limit their liability for other members' default.<sup>198</sup>

In addition, the legal lending limit applies to a federal banking entity's credit exposure to a central counterparty (CCP), including the initial margin it posts to the CCP and any contributions it makes to the CCP's guaranty fund.<sup>199</sup>

## **Risk Identification**<sup>200</sup>

### *Price Risk*

Price risk is the risk to current or projected financial condition and resilience arising from changes in the value of assets. Price risk arises from investing and dealing in derivatives. While smaller dealers may hedge completely their price risk by engaging in perfectly matched derivatives transactions, larger dealers may manage their risks for certain asset classes on a "portfolio" basis, i.e., they hedge "net" risk exposures across all of the transactions in a portfolio. Portfolio hedging reduces the transaction costs involved in hedging each trade as it occurs but can create price risk. Price risk can arise from unhedged, or poorly hedged, trading exposures and result in losses in the portfolio as market factors change. The degree of price risk of an individual transaction depends on the price sensitivity of the financial position, and the time it takes to liquidate or offset (close out) the position. Price sensitivity is generally greater for instruments with leverage, longer maturities, or complex structures (e.g., multiple risk factors), and option features. While risk measurement systems assume that a position can be closed out in

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<sup>196</sup> OCC IL 1122, 1113.

<sup>197</sup> OCC IL 1102.

<sup>198</sup> OTS IL P-2006-7.

<sup>199</sup> 12 USC 84; 12 CFR 32.9(b)(3). The bank's EIC may establish a lower limit as a prudential matter. See OCC IL 1071, 1014, 929.

<sup>200</sup> See generally *Comptroller's Handbook*, "Risk Management of Financial Derivatives" (February 1998).

a day, in deep and liquid markets, federal banking entities can close out even large risk positions within minutes. In less liquid markets, closing out may take much longer.

### *Interest Rate Risk*

Interest rate risk is the risk to current or projected financial condition and resilience arising from movement of interest rates. It arises from differences between the timing of rate changes and the timing of cash flows (repricing risk); from changing rate relationships among yield curves that affect federal banking entity activities (basis risk); from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest-rate-related options embedded in federal banking entity products (option risk). Although interest rate risk arises in all types of financial instruments, it is most noticeable in debt instruments, derivatives that have debt instruments as their underlying reference asset, and other derivatives whose values are linked to market interest rates. In general, the values of longer-term instruments are typically more sensitive to interest-rate changes than the values of shorter-term instruments.

National banks' derivatives dealing activities involve significant interest rate risk. Approximately 76.3 percent of notional derivatives in the banking system involve interest rate contracts.<sup>201</sup> Moreover, revenue from dealing interest rate contracts has historically been the driver of bank trading revenue.

Federal banking entities also take interest rate risk when they use interest rate derivatives as end-users to manage their structural balance sheet positions.

### *Liquidity Risk*

Liquidity risk is the risk to current or projected financial condition and resilience arising from a federal banking entity's inability to meet its obligations when they come due without incurring unacceptable losses. Federal banking entities face two forms of liquidity risk when trading derivatives: funding liquidity risk and market liquidity risk.

Funding liquidity risk is the risk that a federal banking entity may be unable to meet funding requirements associated with its derivatives activities at a reasonable cost. Such funding requirements arise each day from cash flow mismatches in swap books, the exercise of options, dynamic hedging strategies, and margin calls.

Market liquidity risk is the risk that a federal banking entity may not be able to exit or offset positions quickly, and in sufficient quantities, at a reasonable price. This inability may be due to inadequate market depth, market disruption, or the inability of the federal banking entity to access the market. Federal banking entities that are market makers in over-the-counter derivatives, or that dynamically hedge their positions, require constant access to financial markets, especially in times of market stress. Market access can be a particular problem if there are concentrations. Some complex derivative products lack depth because of relatively fewer

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<sup>201</sup> OCC, [Quarterly Report on Bank Trading and Derivatives Activities: First Quarter 2016](#), at 14.

market participants, but even normally liquid markets can become illiquid during periods of market disruption.

### *Credit Risk*

Credit risk is the risk to current or projected financial condition and resilience arising from a counterparty's failure to perform an obligation, typically paying a debt. Federal banking entities face two general forms of credit risk in trading derivatives: pre-settlement risk and settlement risk. Pre-settlement risk is the risk of loss due to a counterparty defaulting on a contract during the life of a transaction. Settlement risk is the loss exposure arising when a federal banking entity's counterparty fails to make a payment when due.

### **Risk Mitigation**

Dodd–Frank has substantially reduced the risks that derivatives may pose to federal banking entities. Margin and clearing requirements and the revised legal lending limit will substantially reduce the amount of credit risk that swaps create for federal banking entities, and the legal lending limit caps what credit exposure remains. Additionally, certain swaps are subject to the prudential safeguards of the Volcker Rule. Finally, updated capital standards will require federal banking entities to maintain adequate capital against swaps' market risk.

### *Volcker Rule*

Section 619 of Dodd–Frank (the Volcker Rule) prohibits proprietary trading in derivatives, securities, and futures, subject to certain exceptions. For a discussion of the Volcker Rule and how it mitigates risk, see “Securities—Risk mitigation—Volcker Rule.”

### *Swaps Margin and Clearing*

Title VII of Dodd–Frank significantly reduces the credit risk in the swaps market by creating margin requirements for swaps and security-based swaps (collectively, swaps). Margin comes in two forms: initial and variation. Initial margin is akin to a performance bond. Variation margin is the daily exchange of the swap's profits and losses.

Dodd–Frank sections 731 and 764 require the federal prudential regulators jointly to impose initial and variation margin requirements for bank swap dealers and major swap participants on all swaps that are not cleared.<sup>202</sup> Cleared swaps, on the other hand, are subject to the margin requirements set by the applicable clearinghouse.

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<sup>202</sup> 7 USC 6s(e)(2)(A)(ii); 15 USC 78o-10(e)(2)(A)(ii). The prudential regulators proposed an implementing rule in 2011. OCC et al., “Margin and Capital Requirements for Covered Swap Entities,” 76 Fed. Reg. 27564 (May 11, 2011). In 2012 and 2013, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions proposed and finalized an international framework for swap margin requirements. The prudential regulators re-proposed their swap margin rule in light of the international framework. OCC et al., “Margin and Capital Requirements for Covered Swap Entities,” 79 Fed. Reg. 57348 (September 24, 2014). The comment period for the re-proposal closed November 24, 2014. The agencies are deciding how to proceed with the rule in light of public comments.

Margin reduces credit risk in a variety of ways. First, it reduces leverage in the system by requiring market participants to collateralize credit exposure. Second, initial margin reduces contagion risks. Absent margin, if a market participant defaulted, then its counterparties would bear any losses. The losses could be significant enough to cast doubt on a counterparty's ability to perform, creating a material risk management problem for the counterparty's other counterparties. Third, initial margin should reduce systemic risk by forcing market participants to internalize the cost of the risks they create. Fourth, margin requirements encourage market participants to clear swaps.<sup>203</sup>

Central clearing can yield additional advantages over a market with bilateral margining arrangements by increasing transparency, reducing credit risk through multilateral netting, and providing a more organized process of handling counterparty defaults. One consequence of increased central clearing, however, is that credit risk that historically was more widely distributed on a bilateral basis has become concentrated in a small number of CCPs.<sup>204</sup> Those credit concentrations, the interconnectedness that results from having large entities as members of multiple CCPs, and CCP rules relating to guaranty fund contributions, can create systemic risk.<sup>205</sup>

### *Lending Limits*

The legal lending limit prevents a federal banking entity from having undue credit concentrations. It imposes quantitative limits on the amount of a federal banking entity's total outstanding loans and extensions of credit to any one borrower.<sup>206</sup>

In recent years, a substantial portion of federal banking entities' credit risk has arisen from derivatives, repurchase and reverse repurchase agreements (repos), and securities borrowing and lending. Dodd–Frank modernized the legal lending limit to include these forms of credit exposure. The revised lending limit promotes federal banking entities' safety and soundness by

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<sup>203</sup> Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, [Margin requirements for non-centrally cleared derivatives](#) (September 2013).

<sup>204</sup> See FSOC, *2015 Annual Report* at 11 (May 2015) (“[T]he increasing importance of CCPs has heightened public and regulatory focus on risk management practices at CCPs and the potential threat to financial stability in the event of a CCP failure.”).

<sup>205</sup> Financial market utilities designated by the FSOC are subject to enhanced supervision under Dodd–Frank. See 12 USC 5461 et seq.

<sup>206</sup> A national bank's total outstanding loans and extensions of credit to one borrower may not exceed 15 percent of the bank's capital and surplus, plus an additional 10 percent of the bank's capital and surplus if the amount that exceeds the bank's 15 percent general limit is fully secured by readily marketable collateral. Consequently, a national bank's maximum credit exposure to a single person from loans and extensions of credit is 25 percent of the bank's capital and surplus. 12 USC 84. Federal savings associations are subject to the same limits, with certain exceptions. See 12 USC 1464(u).

limiting concentrations of credit exposure from derivatives, repos, and securities borrowing and lending. In 2012, the OCC issued a regulation implementing this amendment to 12 USC 84.<sup>207</sup>

### *Swaps Push-out*

Section 716 of Dodd–Frank<sup>208</sup> prohibits providing federal assistance to a registered swap dealer, unless it limits its swaps activities as described further in this paper. The prohibition on federal assistance does not apply to an insured depository institution that limits its swap activities to hedging and dealing (except dealing in structured finance swaps, defined as swaps on asset-backed securities). By rule, the prudential regulators may allow dealing in structured finance swaps of a certain credit quality and type or category.

### *Heightened Standards for Risk Management*

On September 11, 2014, the OCC published heightened, enforceable standards for large federal banking entities' risk management. For example, the standards set forth the roles and responsibilities for frontline units, independent risk management, and internal audit. These organizational units are fundamental to the design and implementation of a risk governance framework and, together, should establish an appropriate system to control risk taking. In addition, the standards provide that a large federal banking entity should have a comprehensive, written risk appetite statement that includes qualitative components and quantitative limits. The qualitative components should describe a safe and sound risk culture and how the federal banking entity will assess and accept risks. The quantitative limits should incorporate sound stress testing processes and should address the federal banking entity's earnings, capital, and liquidity. Finally, the standards assign important responsibilities to a federal banking entity's board of directors in overseeing the design and implementation of the risk governance framework.

### *Enhanced Capital Standards*

In October 2013, the OCC, the Board, and the FDIC adopted a revised capital framework that replaces their existing risk-based and leverage capital rules. The revised capital framework incorporates revisions to the Basel international capital framework (Basel III). Specifically, the revised capital framework strengthens the definition of regulatory capital, increases risk-based capital requirements, and amends the methodologies for determining risk-weighted assets that apply to all national banks and federal savings associations, subject to various transition periods.

The revised capital framework emphasizes common equity tier 1 capital, the most loss-absorbing form of capital, and implements strict eligibility criteria for regulatory capital instruments. In addition, the final rule establishes limits on a banking organization's capital distributions and

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<sup>207</sup> OCC, "Lending Limits," 77 Fed. Reg. 37265 (June 21, 2012) (interim final rule) and 78 Fed. Reg. 37930 (June 25, 2013) (final rule).

<sup>208</sup> 15 USC 8305.

certain discretionary bonus payments if the banking organization does not maintain a buffer of common equity tier 1 capital above minimum risk-based capital requirements.

For the advanced approaches federal banking entities (generally those with at least \$250 billion in total consolidated assets or at least \$10 billion in total on-balance-sheet foreign exposures), the revised capital framework includes a countercyclical capital buffer, additional capital charges and standards for derivatives exposures, and a supplemental leverage ratio that takes into account a broader set of exposures (such as off-balance-sheet exposures). Additionally, the largest, most interconnected U.S. banking organizations are further subject to an enhanced supplemental leverage ratio (ESLR), as these entities' failures have the potential to result in significant adverse economic consequences and to contribute to systemic distress on a domestic and an international scale. The ESLR applies to U.S. top-tier BHCs with more than \$700 billion in consolidated total assets or more than \$10 trillion in assets under custody and their insured depository institution subsidiaries.

### *Enhanced Examination Procedures for End-User Derivatives*

On March 24, 2014, the OCC enhanced its procedures for examining federal banking entity activities that involve entering into derivatives as an end-user rather than a dealer.<sup>209</sup> These procedures supplement the OCC's existing examination procedures, providing more guidance to examiners of large federal banking entities. The procedures focus on identifying the risks created in an active end-user derivatives portfolio. They address minimum scope and ongoing monitoring procedures related to all aspects of a federal banking entity's end-user derivatives activity. Examiners perform the minimum scope procedures at least annually for each federal banking entity that engages in significant end-user derivatives activity to inform the OCC's core assessment of the federal banking entity. Examiners perform the ongoing monitoring procedures regularly to stay abreast of developments in the federal banking entity's risk profile.

## **Recommendations**

### *Clarify Minimum Standards for Derivative Dealing*

The OCC is aware that smaller national banks have expressed increased interest in establishing and expanding swap dealing businesses, particularly in commodity swaps. For example, a community bank might offer a swap to a mid-market energy or agriculture business in connection with a loan. Congress determined this service is appropriate for national banks.<sup>210</sup> They must conduct the business, however, in a safe and sound manner. To ensure that they

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<sup>209</sup> OCC Bulletin 2014-8, "End-User Derivatives and Trading Activities: Comptroller's Handbook Supplemental Examination Procedures" (March 24, 2014).

<sup>210</sup> See 7 USC 1a(49)(A) (insured depository institution is not a swap dealer to the extent that it offers to enter into swaps in connection with originating loans); 7 USC 1a(49)(D) (person engaged in a de minimis quantity of swap dealing is not a swap dealer); 156 Cong. Rec. S3141 (May 5, 2010) (statement of Sen. Lincoln) ("Community banks offering a swap in connection with a loan to a commercial customer are also still in the business of banking and will not be impacted [by section 716].").

establish a prudent control framework for their swap dealing, the OCC intends to clarify minimum prudential standards applicable to national banks engaged in certain swap dealing activities.

### *Review Federal Banking Entities' Risk Management of Clearinghouse Memberships*

The OCC is reviewing the risks to federal banking entities posed by memberships in clearinghouses, particularly clearinghouses with rules that do not cap members' liability.<sup>211</sup> The OCC will evaluate whether guidance on membership in these clearinghouses is appropriate.

## Physical Commodities

### Legal Authority

#### *Investment*

The National Bank Act authorizes national banks to buy and sell “exchange, coin and bullion.” OCC precedent has construed *coin* and *bullion* to include gold, silver, platinum, palladium, and copper.<sup>212</sup>

Federal banking entities may, in certain cases, invest in companies that invest in or run a commodities business. For example, federal banking entities may invest in small business investment companies, subject to a limit of 5 percent of capital and surplus.<sup>213</sup> Although the activities of small business investment companies are limited, they can invest in physical commodities and companies whose business involves shipping, storing, and trading physical commodities. Similarly, national banks may invest in renewable fuel capital investment companies up to 5 percent of capital and surplus.<sup>214</sup> These companies invest in smaller enterprises that develop, produce, or bring to market goods, products, or services that generate or support the production of renewable energy.

National banks also may acquire exposure to physical commodities through their public welfare investment authority, 12 USC 24(Eleventh). This statute authorizes national banks to make investments that primarily promote the public welfare, including the welfare of low- and

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<sup>211</sup> See generally FSOC, *2015 Annual Report* at 11 (“[T]he Council recommends that the agencies continue to evaluate whether certain CCP-related risk areas are being addressed adequately, in particular... (2) bank-CCP interactions and risk management, including how banks and other clearing members manage and account for their potential exposures to the full range of CCPs, both foreign and domestic, in which they participate.”).

<sup>212</sup> 12 USC 24(Seventh); OCC IL 693, 685, 553. National banks may invest in coin and bullion indirectly, via an exchange-traded fund or other investment company that invests only in bank-permissible precious metals. 12 CFR 1.3(h); OCC IL 1013.

<sup>213</sup> 15 USC 682(b).

<sup>214</sup> 15 USC 690i.

moderate-income communities or families (such as by providing housing, services, or jobs).<sup>215</sup> A common type of public welfare investment related to physical commodities is an investment in a company that generates renewable energy,<sup>216</sup> but less conventional investments are possible.<sup>217</sup> A national bank may not make public welfare investments that, in the aggregate, exceed 5 percent of capital and surplus (15 percent with OCC approval), nor may the bank make investments that expose it to unlimited liability.<sup>218</sup>

### *Hedging*

National banks may purchase and sell title to physical commodities, within limits, to hedge commodity price risk in connection with permissible customer-driven commodity derivative transactions.<sup>219</sup> In certain cases, a physical hedge may be more effective than a cash-settled hedge. For example, a national bank entering into a customized commodity swap with a customer is unlikely to find another market participant trading exactly the same swap. The bank could hedge with a future, but that creates basis risk.<sup>220</sup> Hedging with a physical position might involve less basis risk.<sup>221</sup>

### *Other Activities*

The National Bank Act authorizes a national bank to acquire physical commodities in satisfaction of a DPC. For example, a loan to a farmer may be secured by grain, and if the farmer defaults, the bank could foreclose on the grain collateral.<sup>222</sup> The Supreme Court and lower federal courts have long construed national banks' DPC authority broadly. A national bank may not hold DPC property indefinitely—in general, it must divest DPC property within five years—nor may the bank hold DPC property for speculative purposes.<sup>223</sup>

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<sup>215</sup> The OCC's implementing regulations are at 12 CFR 24.

<sup>216</sup> See OCC *Community Developments*, "Investing in Solar Energy Using Public Welfare Investment Authority" (July 2011).

<sup>217</sup> See, e.g., OCC Community Development Investment Letter 2005-3 (indirect investment in an ethanol facility that provided jobs to a rural, low-income community).

<sup>218</sup> 12 CFR 24.4.

<sup>219</sup> OCC IL 1060, 1040, 962, 937, 684, 632.

<sup>220</sup> Basis risk is the risk to current or projected financial condition and resilience that the price fluctuations of the hedging instrument will not match the price fluctuations of the underlying transaction.

<sup>221</sup> Basis risk can arise in a variety of ways, including mismatches between the hedge and the underlying transaction relating to the type of commodity involved or the geographic location of such commodity.

<sup>222</sup> See *First Nat'l Bank of Parker v. Peavy Elevator Co.*, 10 S.D. 167, 170 (1897). See also OCC IL 12 (purchase of an ammonia plant at foreclosure auction).

<sup>223</sup> Cf. 12 CFR 1.7, 34.82.



As part of their authority to buy and sell coin and bullion, national banks may store precious metals for themselves and their customers.<sup>224</sup> The typical example is “vaulting”: safekeeping gold in a bank vault. They may transport precious metals to or from their customers.<sup>225</sup> By extension, the OCC has allowed a national bank to serve as custodian for an exchange-traded fund that invests in bank-permissible metals.<sup>226</sup>

As discussed earlier, national banks may, as part of a customer-driven financial intermediation business, deal in derivatives on commodities in which they cannot invest. In general, national banks must settle these derivatives in cash and not take delivery of the commodity. Settlement by transitory title transfer—whereby the national bank acquires and instantaneously disposes of title to the commodity—is permissible in certain cases.<sup>227</sup>

Federal savings associations may not speculate in precious metals, but they may carry immaterial positions to facilitate customer trades.<sup>228</sup> OCC precedent (including precedent from the OTS) does not authorize federal savings associations to hold physical commodities for hedging or other purposes.

## Risk Identification

### *Price Risk*

Price risk is the risk to current or projected financial condition and resilience arising from changes in the value of assets. Commodity prices are typically more volatile than most commonly traded financial assets; physical commodities are traded in markets in which the concentration of supply can magnify price volatility. Moreover, fluctuations in market liquidity often accompany high price volatility.

### *Operational Risk*

Operational risk is the risk to current or projected financial condition and resilience arising from inadequate or failed internal processes, people, and systems or from external events. For example, a bank that transports gold to its vault faces the risk that its armored car will be at fault in a car accident, creating liability for the bank. Theft is another example of operational risk. Institutions mitigate risks from physical commodities activities by purchasing insurance and by outsourcing, consistent with safe and sound third-party risk management. For example, some

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<sup>224</sup> *Oulton v. German S&L Society*, 84 U.S. 109, 118 (1872). See also letter from John Gwin, Deputy Comptroller, to Ernest Ginsberg, Republic National Bank of New York (October 1, 1969) (storage of silver bullion traded through a commodity exchange).

<sup>225</sup> See 12 CFR 7.1012.

<sup>226</sup> OCC IL 1013.

<sup>227</sup> See OCC IL 1073 (metals derivatives), 1060 (coal derivatives), 962 (electricity derivatives).

<sup>228</sup> OTS IL P-2006-1.

federal banking entities hire third parties to transport or store gold. Other federal banking entities buy insurance to cover the loss of the commodity.

## Risk Mitigation

The OCC recognizes the risks created by owning physical commodities and therefore has imposed stringent limits on physical hedging. First, a national bank may not hedge with physical commodities (other than coin and bullion metals) unless the commodity effectively reduces risks arising from otherwise permissible (customer-driven) banking activities.<sup>229</sup> Second, the physical hedging cannot be more than a nominal portion of the bank's hedging activities;<sup>230</sup> it must supplement the bank's other risk management activities. Third, the bank must obtain supervisory approval before beginning physical hedging activities. The OCC will not allow the bank to begin physically hedging unless and until the bank establishes and demonstrates a comprehensive and robust set of internal controls designed to ensure the activity is safe and sound. The bank should have more sophisticated controls than those required for derivatives activities in general.<sup>231</sup>

## Recommendations

### *Address Copper Trading and Appropriate Limits*

In 1995, the OCC interpreted national bank-permissible coin and bullion activities to include copper.<sup>232</sup> National banks have traded copper for over 20 years. Copper, like gold, silver, platinum, and palladium, is included in some definitions of "precious metals" and comes in bullion form. Unlike these other precious metals, however, copper is also characterized as a base

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<sup>229</sup> See OCC IL 684, 632.

<sup>230</sup> In OCC IL 684, the OCC found that 5 percent was a nominal portion.

<sup>231</sup> See *Comptroller's Handbook*, "Risk Management of Financial Derivatives" (February 1998). The internal controls the OCC expects include

- specific written policies and procedures approved by the board of directors that set forth the circumstances under which physical hedging is permissible, establish permissible strategies for physical delivery in such transactions, and address the relationship between the hedges and other banking activities.
- position limits.
- a system for monitoring credit risk exposure associated with various customers and dealers with whom operating personnel are authorized to transact business.
- internal controls designed to ensure adherence to bank policy and to prevent unauthorized trading and other abuses, including documentation to support the authorized use of physical hedges, periodic reports to management, segregation of duties, and internal audit programs.
- safeguards designed to manage the risks associated with storing, transporting, and disposing of commodities of which the bank has taken delivery, including policies and procedures designed to ensure that the bank has adequate levels of insurance (including insurance for environmental liabilities) that, after deductions, are commensurate with the risks assumed.
- minimum qualifications and appropriate training requirements for bank employees engaged in physical hedging.

<sup>232</sup> OCC IL 693.

metal. Recently, the U.S. Senate Permanent Subcommittee on Investigations recommended that the OCC subject copper to the same limits and reporting requirements that apply to other base metals.<sup>233</sup>

The OCC will publish 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. The OCC will consider public comments in determining how to proceed and publish any revisions to existing precedent.

### *Clarify Physical Hedging Limits*

The OCC believes it would be helpful to clarify existing limits on physical hedges. Current precedent requires physical hedges to be a “nominal” portion of a national bank’s hedging activity, and the OCC has found that 5 percent is nominal. However, precedents do not specify how national banks should calculate how much of their hedging involves physical settlement. The OCC recently published supervisory guidance that clarifies the methodology for calculating physical hedging restrictions.<sup>234</sup>

## Securities

### Legal Authority

#### *Investment Securities*

National banks are authorized to purchase investment securities for investment subject to any limitations and restrictions that the OCC prescribes.<sup>235</sup> In general, a national bank may not own investment securities issued by any single obligor in excess of 10 percent of its capital and surplus, but the statute contains several exceptions.<sup>236</sup>

The statute authorizes the Comptroller to further define *investment security*. The OCC’s implementing regulation, 12 CFR 1 (part 1), defines *investment security* as a marketable debt obligation that is investment grade and not predominately speculative in nature.<sup>237</sup> Part 1 classifies investment securities into five types.

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<sup>233</sup> U.S. Senate Permanent Subcommittee on Investigations, *Wall Street Bank Involvement With Physical Commodities* 10 (November 20, 2014).

<sup>234</sup> OCC Bulletin 2015-35, “Quantitative Limits on Physical Commodity Transactions” (August 4, 2015).

<sup>235</sup> 12 USC 24(Seventh). State banks are subject to the same limitations. 12 USC 335, 1831a.

<sup>236</sup> 12 USC 24(Seventh).

<sup>237</sup> 12 CFR 1.2(e). Hybrid instruments—instruments containing both debt and equity features—may be debt securities, depending on the particular facts and features of the instrument. E.g., OCC IL 1021, 826, 777.

*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 percent capital limit. Type I securities include

- obligations of the United States.
- obligations of federal agencies backed by the full faith and credit of the United States.
- general obligations of a state or any political subdivision of a state.
- state and municipal limited obligations and revenue bonds (if the bank is well capitalized).
- securities issued or guaranteed by Ginnie Mae, Fannie Mae, and Freddie Mac.

*Type II securities* are investment securities that national banks may deal in, underwrite, purchase, and sell, subject to the 10 percent capital limit. Type II securities include obligations of certain international and multilateral development banks, the Tennessee Valley Authority, and the U.S. Postal Service.

*Type III securities* are investment securities that are not Type I, II, IV, or V securities. A national bank may invest in Type III securities subject to the 10 percent capital limit but may not underwrite or deal in them. The most common Type III securities are investment grade corporate bonds and investment grade sovereign bonds.<sup>238</sup>

*Type IV and V securities* are discussed further in “Structured Products—Legal Authority.”

Federal savings associations may invest in, purchase, sell, participate in, or deal in many of the same securities as national banks. HOLA and its implementing regulation list the various permitted securities and any associated limits.<sup>239</sup> The implementing regulation, 12 CFR 160.30, lists the following permissible debt securities:

- Federal government obligations
- Securities and instruments of certain GSEs, including Fannie Mae, Freddie Mac, and Ginnie Mae
- State and local government obligations
- Obligations of state housing corporations
- Commercial paper
- Investment grade corporate debt securities<sup>240</sup>
- Small-business related securities

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<sup>238</sup> Obligations of the United States or Canada are Type I securities. Obligations of certain multilateral or international organizations are Type II securities.

<sup>239</sup> 12 USC 1464(c), 12 CFR 160.30.

<sup>240</sup> For federal savings associations, a corporate debt security is investment grade if it meets the standards of creditworthiness described in 12 USC 1831e and 12 CFR 362.11(b).

### *Other Debt Investments*

National banks may invest in debt securities that are not investment securities in two ways: under the reliable estimates authority or as loans. 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.<sup>241</sup> The aggregate par value of these securities may not exceed 5 percent of the bank's capital and surplus.

Second, as the Supreme Court has explained, a national bank may purchase a debt security under its express authority to discount and negotiate evidences of debt.<sup>242</sup> Debt securities acquired under this authority are considered loans. Instead of the part 1 limits described above, the legal lending limit applies. National banks wishing to purchase a debt security as a loan must underwrite the security as they would a loan.<sup>243</sup>

By analogy to national banks' lending authority, the OCC has determined that federal savings associations may use their lending authority to purchase certain securities.<sup>244</sup>

### *Equity Investments*

While 12 USC 24(Seventh) generally prohibits national banks from making equity investments, it and other statutes permit several kinds of equity investments. Many of these statutes also authorize these investments for federal savings associations. Examples of permissible equity investments include

- various GSEs: the federal home loan banks, Fannie Mae, Freddie Mac, Farmer Mac, and Sallie Mae.<sup>245</sup>
- small business investment companies.<sup>246</sup>

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<sup>241</sup> 12 CFR 1.3(i).

<sup>242</sup> *Nat'l Bank of Gloversville v. Johnson*, 104 U.S. 271, 277 (1881); accord OCC IL 908, 834, 833, 600, 579, 182.

<sup>243</sup> OCC Bulletin 2002-19, "Unsafe and Unsound Investment Portfolio Practices: Supplemental Guidance" (May 22, 2002).

<sup>244</sup> OCC IL 1135. If a federal savings association invests in a corporate debt security, it must be investment grade; the federal savings association must determine, prior to acquiring the security and periodically thereafter, that the issuer has adequate capacity to meet all financial commitments under the security for the security's projected life. See 12 USC 1831e(d)(1); 12 CFR 362.11(b).

<sup>245</sup> 12 USC 24(Seventh) (Fannie Mae, Freddie Mac, Ginnie Mae, Sallie Mae); 12 USC 1424(a)(1), 1426(c)(1) (federal home loan banks); 12 USC 1464(c)(1)(D)–(F) (Fannie Mae, Freddie Mac, Ginnie Mae, Sallie Mae, federal home loan banks); 12 USC 1718(d) (Fannie Mae); 15 USC 77r-1(a) (Fannie Mae, Freddie Mac); OCC IL 755 (federal home loan banks), 427 (Farmer Mac); OTS IL P-97-11 (Farmer Mac).

<sup>246</sup> 15 USC 682(b).

- certain housing projects.<sup>247</sup>
- new markets venture capital companies.<sup>248</sup>
- rural business development companies.<sup>249</sup>
- renewable fuel capital investment companies.<sup>250</sup>

A national bank may also make equity investments that are public welfare investments, up to 5 percent of capital and surplus (15 percent with OCC approval).<sup>251</sup> A national bank may also buy an equity stake in a community and economic development entity, which is an entity that makes public welfare investments.<sup>252</sup> Under OCC regulations, public welfare investments must primarily benefit low- and moderate-income individuals, low- and moderate-income areas, or other areas targeted by a governmental entity for redevelopment, or they must be “qualified investments” under the CRA’s implementing regulation.<sup>253</sup>

A federal savings association may make a public welfare equity investment of the type permissible for a national bank if the investment does not exceed 1 percent of its total capital or \$250,000, whichever is greater.<sup>254</sup> It may also make community development equity investments up to 2 percent of total assets.<sup>255</sup>

Part 1 permits a national bank to invest in a fund that invests only in assets that the bank could purchase and sell for its own account.<sup>256</sup> Similarly, a national bank may own an interest in an insurance company separate account if the account contains only bank-permissible assets.<sup>257</sup> A federal savings association may invest in a mutual fund if the fund’s portfolio consists only of investments that a federal savings association could make without limitation.<sup>258</sup> Subject to

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<sup>247</sup> 12 USC 24(Seventh).

<sup>248</sup> 15 USC 689h.

<sup>249</sup> 7 USC 2009cc-9.

<sup>250</sup> 15 USC 690i.

<sup>251</sup> 12 USC 24(Eleventh).

<sup>252</sup> 12 CFR 24.2(c) defines “community and economic development entity.”

<sup>253</sup> 12 CFR 24.3.

<sup>254</sup> 12 CFR 160.36.

<sup>255</sup> 12 USC 1464(c)(3)(A); 12 CFR 160.30.

<sup>256</sup> 12 CFR 1.3(h).

<sup>257</sup> OCC IL 826.

<sup>258</sup> 12 USC 1464(c)(1)(Q); 12 CFR 160.30.

certain requirements, a federal savings association may also invest in an entity that only conducts activities the association could conduct directly.<sup>259</sup>

### *Hedging*

With prior supervisory non-objection, national banks may own equity securities to hedge customer-driven equity derivatives.<sup>260</sup> Likewise, they may use below-investment-grade debt securities to hedge customer-driven derivatives on below-investment-grade debt securities.<sup>261</sup>

### *DPC and Nonconforming Investments*

A national bank may acquire securities in satisfaction of debts previously contracted, through foreclosure on collateral, in good faith by way of compromise of a doubtful claim, or to avoid loss in connection with a debt previously contracted.<sup>262</sup> A national bank must dispose of these securities within five years; the OCC may extend the holding period by up to five years if the bank provides a clearly convincing demonstration as to why it needs an extension.<sup>263</sup>

Federal savings associations have analogous authority: the inherent authority to salvage investments by making investments or acquiring assets not authorized under their express powers.<sup>264</sup> The “salvage” authority includes acquiring securities that would otherwise be impermissible investments.<sup>265</sup>

### *Other Activities*

National banks may underwrite and deal in Type I and Type II securities.<sup>266</sup> National banks may privately place securities<sup>267</sup> and engage in various securities brokerage activities.<sup>268</sup> A national

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<sup>259</sup> 12 CFR 160.32.

<sup>260</sup> OCC IL 892.

<sup>261</sup> OCC IL 935.

<sup>262</sup> 12 CFR 1.7(a).

<sup>263</sup> 12 CFR 1.7(b).

<sup>264</sup> FHLBB OGC Opinion B-50 (July 1, 1941).

<sup>265</sup> Letter from Karen Solomon, Deputy Chief Counsel, OTS, to Frederick R. Casteel, Regional Director, Midwest Region, OTS (October 6, 1993), 1993 WL 495609 (acquiring stock); Letter from Karen O’Konski Solomon, Associate General Counsel, Federal Home Loan Bank Board (FHLBB), (June 29, 1988), 1988 WL 1021678 (acquiring preferred stock).

<sup>266</sup> 12 USC 24(Seventh).

<sup>267</sup> *Sec. Indus. Ass’n v. Board of Governors, Federal Reserve*, 807 F.2d 1052 (D.C. Cir. 1986), cert. denied, 483 U.S. 1005 (1987).

bank may advise and manage a private investment fund and accept limited equity interests in the fund as compensation.<sup>269</sup>

A federal savings association may act as principal or agent to underwrite, deal in, or otherwise buy, hold, sell, or find buyers for investment-grade debt securities that are not asset-backed securities.<sup>270</sup> The association may also provide securities clearing and related services<sup>271</sup> and engage in riskless principal transactions on securities regardless of whether the association could hold the securities for its own account.<sup>272</sup>

## Risk Identification<sup>273</sup>

### *Interest Rate Risk*

Interest rate risk is the risk to current or projected financial condition and resilience arising from movement of interest rates. While interest rate risk arises in many types of financial products, it is most noticeable in debt instruments with yields tied to interest rates. For a bond that the federal banking entity does not intend to hold to maturity, the federal banking entity accounts for the bond at fair (market) value. If interest rates decline below the bond's yield, the bond will increase in price; if interest rates rise above the bond's yield, the bond will decrease in price. Generally, the longer the duration of a debt security, the more sensitive its value is to changes in interest rates. Federal banking entities measure interest rate risk by evaluating the effect of changing rates or prices on the economic value of a security, a portfolio, or the federal banking entity's equity.

### *Credit Risk*

Credit risk is the risk to current or projected financial condition and resilience arising from a counterparty's failure to perform an obligation, typically paying a debt. All debt securities carry

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<sup>268</sup> See, e.g., 15 USC 78q-1(c) (transfer agent); 15 USC 78c(a)(4)(B)(viii)(I)(aa) (custodian); 15 USC 78q-1(b)(3)(B)(iv) (member of clearing agency); 15 USC 78c(a)(4)(B)(viii)(I)(bb) (clearing or settling transactions); OCC IL 371 (riskless principal transactions); OCC Banking Circular 196, "Securities Lending" (May 7, 1985) (securities lending).

<sup>269</sup> 12 USC 24(Seventh), 92a. The cap on the amount of the equity interest depends on the facts and circumstances. In OCC Conditional Approval 1018, the OCC limited the national bank's investment in any single fund it advised to 2.5 percent of the fund's equity and the bank's investment in all funds it advised to 2.5 percent of capital.

<sup>270</sup> OTS Order 2006-23 (June 1, 2006).

<sup>271</sup> OTS IL P-2006-7.

<sup>272</sup> OCC IL 1135 (citing Memorandum to Office of District Banks from FHLBB Deputy General Counsel (January 15, 1988)).

<sup>273</sup> See generally FFIEC, "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities," 63 Fed. Reg. 20191 (April 23, 1998).



some credit risk. For example, a federal banking entity that buys a corporate bond assumes the credit risk that the corporation will not repay the debt. Federal banking entities assess credit risk through pre-purchase due diligence reviews to ensure repayment capacity and then on an ongoing basis throughout the holding period.

### *Liquidity Risk*

Liquidity risk is the risk to current or projected financial condition and resilience arising from a federal banking entity's inability to meet its obligations when they come due without incurring unacceptable losses. Many federal banking entities regularly sell assets to raise cash to fund operations. Sales from a federal banking entity's investment portfolio (including sales subject to repurchase) are an important but not primary source of liquidity for most federal banking entities. Asset sales have liquidity risk because the federal banking entity may fail to recognize or address changes in market conditions that affect its ability to liquidate assets quickly and with minimal loss in value. Different instruments have different liquidity risks; relevant factors include the issuer's credit quality, the effect of embedded options, market depth, or disruptions in the marketplace. The federal banking entity's management generally will assess liquidity risk in the broader context of the institution's overall liquidity.

## **Risk Mitigation**

### *Volcker Rule*

Section 619 of Dodd–Frank (the Volcker Rule)<sup>274</sup> imposes stringent limitations on federal banking entities' trading and asset management activities. Subject to limited exceptions, it prohibits a federal banking entity from

- engaging in proprietary trading.
- having an ownership interest in, or sponsoring, a hedge fund or private equity fund.
- entering into certain transactions that create credit exposure with hedge funds and private equity funds that the federal banking entity sponsors or advises.

Under the Volcker Rule's implementing regulation,<sup>275</sup> federal banking entities with total assets of \$50 billion or more or gross trading assets and liabilities of \$10 billion or more must establish, maintain, and enforce a rigorous compliance program. They must set limits on trading positions and risks, hold senior management accountable for Volcker compliance, provide trading desks with specific and detailed trading mandates, conduct independent testing of the compliance program, document hedging strategies, and establish robust internal controls for trading processes.

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<sup>274</sup> 12 USC 1851.

<sup>275</sup> 12 CFR 44.

Federal banking entities with gross trading assets and liabilities above certain thresholds must regularly report to the OCC several quantitative metrics for each trading desk.<sup>276</sup> The metrics also may be useful in determining if a trading desk is taking prudent risks conducting trading that the Volcker Rule permits—or if it is engaged in inappropriately risky or speculative trading.

The Volcker Rule’s prohibition on hedge funds and private equity funds has the following two objectives: first, to prevent federal banking entities from circumventing the restrictions on proprietary trading by shifting their trading activities to federal banking entity-run hedge funds; and second, to limit federal banking entities’ exposure to the risky investing strategies many hedge funds and private equity funds employ.

*Proprietary trading* means buying or selling, as principal, a security, derivative, or future with the principal purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one of these short-term positions (collectively, short-term purposes). The purchase (or sale) of a financial instrument is presumed to be principally for a short-term purpose if a federal banking entity holds the financial instrument for fewer than 60 days or substantially transfers the risk of the financial instrument within 60 days of the purchase (or sale), unless the federal banking entity can demonstrate, based on all relevant facts and circumstances, that it did not purchase (or sell) the financial instrument principally for a short-term purpose.

Proprietary trading also includes purchases and sales that are covered positions and trading positions under the market risk capital rule<sup>277</sup> (if the federal banking entity or its holding company is subject to the market risk capital rule) and purchases and sales of securities and swaps in connection with dealing activities.

The Volcker Rule contains a limited number of “permitted activities,” namely forms of permissible proprietary trading. The permitted activities most relevant to federal banking entities are

- trading in domestic government obligations.
- activities related to market making.
- risk-mitigating hedging activities.
- trading on behalf of customers.

The market-making and hedging exceptions each contain requirements to ensure that federal banking entities are not speculating in the guise of permitted trading. For example, market-making desks may not have more inventory than needed to satisfy reasonably expected near-term customer demand. They must have well-defined and robust internal controls, including risk and position limits. Desks that hedge must show that the hedges are effective at inception and keep

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<sup>276</sup> The threshold for reporting metrics is \$50 billion beginning on June 30, 2014; \$25 billion beginning on April 30, 2016; and \$10 billion beginning on December 31, 2016. 12 CFR 44.20(d)(2).

<sup>277</sup> 12 CFR 3, appendix B.

them effective throughout the life of the hedge. They may not put on a “hedge” that creates significant new risks.

The Volcker Rule imposes additional restrictions prohibiting permitted activities that

- involve or result in material conflicts of interest between a federal banking entity and its clients, customers, or counterparties,
- result in material exposures to high-risk assets or trading strategies, or
- pose a threat to the federal banking entity’s safety and soundness or to U.S. financial stability.

The final rule also implements the statutory prohibition on having an ownership interest in, or sponsoring, a hedge fund or private equity fund (covered fund). The Volcker Rule permits a federal banking entity to organize and offer a covered fund for its trust and fiduciary customers, subject to various restrictions. For example, after a seeding period, the federal banking entity may own no more than 3 percent of any particular covered fund. In addition, the federal banking entity’s total investment in covered funds it organizes and offers may not exceed 3 percent of its tier 1 capital. The federal banking entity must also tell investors that they, and not the federal banking entity or its affiliates, bear the risk of losses in the fund.

To ensure that a federal banking entity will not bail out investors in covered funds that it runs, the statute and the final rule prohibit the federal banking entity from engaging in covered transactions with any covered fund for which the federal banking entity is the organizer, offeror, sponsor, investment manager, investment adviser, or commodity trading advisor. *Covered transactions* include a variety of forms of loans, extensions of credit, guarantees, asset purchases, and derivatives.<sup>278</sup>

Notwithstanding the prohibition on covered transactions, a federal banking entity may make an investment in a covered fund it organizes and offers as contemplated in the Volcker Rule. A federal banking entity may also offer prime brokerage transactions to a covered fund in which a covered fund run by the federal banking entity has invested.

### ***Enhanced Capital Standards***

The OCC’s enhancements to capital standards apply to securities activities. For a summary of the enhancements, see “Derivatives—Risk mitigation—Enhanced capital standards.”

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<sup>278</sup> 12 USC 371c(b)(7).

## *Removal of Credit Ratings*

Because of section 939A of Dodd–Frank, federal banking entities may not rely exclusively on credit ratings to determine that a security is investment grade and therefore a permissible investment. Section 939A therefore helps federal banking entities better understand the risks in their investment portfolios and make investment decisions that are better informed.

The OCC provided federal banking entities with detailed guidance on the level of diligence it expects for investment securities.<sup>279</sup> As explained in the guidance, the depth of the due diligence should be a function of the security’s credit quality, the complexity of the structure, and the size of the investment. The more complex a security’s structure, the more credit-related due diligence an institution should perform, even when the credit quality is perceived to be very high.<sup>280</sup> The guidance cautioned federal banking entities to be particularly diligent when purchasing structured securities. In particular, the OCC expects federal banking entities to understand the effect economic stress—including severe stress—may have on a structured security’s cash flows.<sup>281</sup>

## **Recommendations**

### *Incorporate the Volcker Rule into the Investment Securities Regulations*

The OCC plans to update its investment securities regulations (12 CFR 1 for national banks and 12 CFR 160 for federal savings associations) to reflect the restrictions in the Volcker Rule and its implementing regulation, 12 CFR 44. These changes would clarify that the Volcker Rule supersedes contrary authority in parts 1 and 160.<sup>282</sup> For example, the amended parts 1 and 160 will not allow federal banking entities to invest in “covered funds” as defined in 12 CFR 44.

## **Structured Products**

### **Legal Authority**

#### *Investment in Asset-backed Securities*

National banks may buy certain asset-backed securities for investment.

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<sup>279</sup> OCC, “Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment,” 77 Fed. Reg. 35259 (June 13, 2012).

<sup>280</sup> Id. at 35261.

<sup>281</sup> Id. at 35262.

<sup>282</sup> 12 USC 1851(g)(1).

*Type I securities.* By statute, mortgage-backed securities guaranteed by Ginnie Mae, Fannie Mae, or Freddie Mac are Type I securities.<sup>283</sup> Asset-backed securities collateralized by federally guaranteed loans or Type I securities are themselves Type I.<sup>284</sup> Similarly, a strip of a Type I security is Type I.<sup>285</sup>

*Type III securities.* National banks may purchase marketable, investment-grade mortgage-backed securities and collateralized bond obligations as Type III securities.<sup>286</sup>

*Type IV securities.* National banks may purchase and sell Type IV securities.<sup>287</sup> Type IV securities include certain small-business-related securities, commercial mortgage-related securities, and residential mortgage-related securities. Examples include private-label mortgage-backed securities, collateralized mortgage obligations, and real estate mortgage investment conduits.

*Type V securities.* National banks may purchase and sell Type V securities, which 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.<sup>288</sup> These loans include small business loans, commercial mortgages, residential mortgages, credit card receivables, and car loans. The loans may back the securities indirectly. For example, securities backed by residential mortgage-backed securities could be Type V securities.<sup>289</sup> A national bank's investment in the Type V securities of any one issuer is limited to 25 percent of capital and surplus.

*Other securities.* National banks may purchase and sell asset-backed securities as loans or using reliable estimates of creditworthiness.<sup>290</sup>

Federal savings associations may invest in structured products backed by assets in which they could directly invest<sup>291</sup> or to the extent that the products are investment grade and marketable

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<sup>283</sup> 15 USC 77d-1; 12 USC 24(Ninth); OCC IL 514.

<sup>284</sup> OCC IL 583.

<sup>285</sup> OCC, "Eligibility of Securities for Purchase, Dealing in, Underwriting and Holding by National Banks," 51 Fed. Reg. 29085, 29087 (August 8, 1986); see also Letter from Eugene Cantor, Counsel, Securities & Corporate Practices Division, to Steven Hunter, Chairman, The Vinton County National Bank of McArthur (May 18, 2010).

<sup>286</sup> OCC IL 7; OCC, *Activities Permissible for a National Bank, Cumulative 84* (April 2012).

<sup>287</sup> 12 CFR 1.3(e).

<sup>288</sup> 12 CFR 1.3(f).

<sup>289</sup> OCC IL 1133.

<sup>290</sup> OCC IL 600.

<sup>291</sup> OTS IL P-2004-5. See also 12 CFR 160.32.

debt securities.<sup>292</sup> Examples of permissible investments include trust-preferred securities, collateralized bond obligations, and collateralized loan obligations.<sup>293</sup> In addition, HOLA authorizes unlimited investments in “mortgage related securities” and “small business related securities,” as those terms are defined in the Securities Exchange Act of 1934.<sup>294</sup> Like national banks, federal savings associations may purchase securities issued or guaranteed by Fannie Mae or Freddie Mac.<sup>295</sup> Also like national banks, federal savings associations may purchase structured products under their lending authority.<sup>296</sup>

### *Investment in Structured Notes*

National banks may purchase structured notes that are debt securities with cash flow characteristics that depend upon one or more indices or with embedded derivatives.<sup>297</sup> A structured note is a Type I security if its principal and a portion of the interest is secured with Type I securities.<sup>298</sup> In addition, marketable and investment-grade structured notes might qualify as Type III securities.<sup>299</sup> The OCC imposes prudential restrictions on investments in certain complex structured products.<sup>300</sup>

*Other securities.* In some instances in which various tax credits are available, federal banking entities may use their public welfare investment authority to purchase structured products.<sup>301</sup> In addition, national banks may purchase structured notes that are debt securities as loans or under the reliable estimates authority.

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<sup>292</sup> 12 CFR 160.40.

<sup>293</sup> See OTS Thrift Bulletin 73a, “Investing in Complex Securities” (December 18, 2001).

<sup>294</sup> 12 USC 1463(c)(1)(R) and (S).

<sup>295</sup> 15 USC 77r-1.

<sup>296</sup> OCC IL 1135.

<sup>297</sup> See OCC Advisory Letter 94-2, “Purchase of Structured Notes” (July 21, 1994). Examples of structured notes include step-up bonds, index amortizing notes, dual index notes, de-leveraged bonds, range bonds, credit-linked notes, and inverse floaters.

<sup>298</sup> OCC IL 767.

<sup>299</sup> See *id.*

<sup>300</sup> For example, in OCC IL 1047, the OCC (1) limited a bank’s investment in a credit-linked note to 1 percent of capital and surplus and (2) limited the opinion to the facts presented, including that the investors would be large banks with assets of over \$25 billion and sophisticated risk management processes.

<sup>301</sup> See, e.g., OCC, *Community Developments Insights*, “Historic Tax Credits: Bringing New Life to Older Communities” (May 2015); OCC, *Community Developments Insights*, “Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks” (March 2014); OCC, *Community Developments Insights*, “Historic Tax Credits: Bringing New Life to Older Communities” (November 2008); OCC, *Community Developments Insights*, “New Markets Tax Credits: Unlocking Investment Potential” (June 2013).

### *Creation and Sponsorship*

A national bank may securitize and sell its assets, whether the bank originated them or purchased them.<sup>302</sup> Securitized products that national banks may issue include mortgage-backed securities, collateralized mortgage obligations, and collateralized debt obligations.<sup>303</sup> They may market these securities, serve as the securitization trustee, service the underlying loans, and serve as payment agent.<sup>304</sup> Finally, they may provide liquidity and credit support to issuers of structured products.<sup>305</sup>

As part of its banking business, a federal savings association may securitize and sell assets in which it may invest (including mortgage loans, credit card receivables, automobile loans and receivables, and other consumer loans) whether originated by the association or purchased from others.<sup>306</sup>

### *DPC and Nonconforming Investments*

The authority to acquire securities in satisfaction of debt previously contracted applies to structured products. A national bank may securitize its nonconforming assets to restructure the investments. Incidental to such a restructuring, a national bank may retain the resulting securities that are not investment securities.<sup>307</sup>

### *Bank-Owned Life Insurance*

Federal banking entities may buy life insurance policies to finance or recover the cost of benefit plans for employees, officers, or directors; insure key employees; reduce credit risk by insuring a borrower; and hedge deferred compensation obligations.<sup>308</sup> If the policy includes a separate account, the separate account may contain structured notes.<sup>309</sup>

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<sup>302</sup> 12 CFR 1.3(g).

<sup>303</sup> OCC IL 514, 378; Letter from Robert Bloom, Acting Comptroller of the Currency, to Leland Prussia, Executive Vice President and Cashier, Bank of America, N.T. & S.A. (March 30, 1977), Fed. Banking L. Rep. ¶ 97,093.

<sup>304</sup> OCC IL 388.

<sup>305</sup> 12 CFR 7.1016; OCC IL 1010, 132.

<sup>306</sup> OTS IL P-2004-5.

<sup>307</sup> OCC IL 1133.

<sup>308</sup> See OCC IL 1030, 878; OCC Bulletin 2004-56, “Bank-Owned Life Insurance: Interagency Statement on the Purchase and Risk Management of Life Insurance” (September 22, 2004).

<sup>309</sup> OCC IL 1030.

## Risk Identification<sup>310</sup>

Structured products are derivatives or securities, so they have the risks inherent in any derivative or security. See “Derivatives—Risk identification” and “Securities—Risk identification.” The following discussion focuses on risks particular to structured products.

### *Interest Rate Risk*

Interest rate risk is the risk to current or projected financial condition and resilience arising from movement of interest rates. Structured products encompass a broad array of instruments with varying levels of complexity. Some contain embedded options that can change the expected cash flow of the security. These options generally give bond issuers or the borrowers on the underlying loans the option to prepay. This feature makes the timing and total amount of cash flows uncertain. This cash-flow uncertainty means that the maturity and duration of the security are uncertain. This uncertainty complicates the mark-to-market valuation. Because interest rate risk depends greatly on a security’s duration, federal banking entities need sophisticated analytics to understand a structured product’s interest rate risk across a range of economic and interest rate scenarios.

### *Credit Risk*

Credit risk is the risk to current or projected financial condition and resilience arising from a counterparty’s failure to perform an obligation, typically paying a debt. The credit risk in structured finance products may present varying levels of complexity depending upon the nature of the exposure. An asset-backed security presents indirect credit risk: the issuer of the security will default if it suffers losses in the underlying collateral. Therefore, the federal banking entity’s credit risk is really to the borrowers of the underlying loans or debt securities. A structured note or similar derivative can have two credit risks: direct credit risk to the issuer and, if the derivative references loans or debt securities, indirect credit risk to the underlying borrowers. It is sometimes difficult to determine who the underlying borrowers are, complicating credit risk analysis.

A federal banking entity is often subject to a structured product’s credit risk even after selling it. Federal banking entities frequently guarantee (or provide other credit support to) asset-backed securities they create. To avoid reputational harm, many federal banking entities provide credit support even when not legally required because of their concerns that investors would be reluctant to buy future issuances if the federal banking entities did not support existing asset-backed securities. Losing access to these investors could substantially increase liquidity risk for federal banking entities that rely on sales of asset-backed securities to satisfy funding needs.

Frequently, structured securities reallocate the risks in the underlying collateral into security tranches that match the investment objectives of investors. Federal banking entities use a variety

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<sup>310</sup> See, generally, FFIEC, “Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities,” 78 Fed. Reg. 20191 (April 23, 1998); *Comptroller’s Handbook*, “Risk Management of Financial Derivatives” (February 1998).



of tools to create tranches with different amounts of risk, such as senior or subordinated structures, overcollateralization, insurance, or letters of credit. Generally, the higher the position in the capital structure and cash flow waterfall the lower the credit risk (and the lower the expected yield).

### *Liquidity Risk*

Liquidity risk is the risk to current or projected financial condition and resilience arising from a federal banking entity's inability to meet its obligations when they come due without incurring unacceptable losses. Liquidity risk varies for structured products. Many structured products are traded in deep, liquid markets during stable market conditions. Many small or complex issues, however, have limited or no secondary trade volume. Interest rate risk can have an effect on the liquidity of some securities. During periods of market volatility and stress, options embedded in an asset-backed security's underlying collateral highlight the security's interest rate risk, making potential purchasers wary. Liquidity risk will also increase if concerns arise regarding credit quality. Accordingly, even securities acquired with good credit quality and high liquidity can become illiquid during periods of market stress, particularly if market participants develop concerns about the underlying credit quality.

## **Risk Mitigation**

### *Risk Retention*

Section 941 of Dodd–Frank provides for 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. When a federal banking entity securitizes its loans or other assets, the statute provides for the securitizer to keep some “skin in the game” and not wholly divest those assets' credit risks.

The amount of credit risk a securitizer must retain depends on the assets being securitized. In general, a securitizer must retain 5 percent of the securitization's credit risk. The required risk retention is less than 5 percent if the underlying assets are “qualified residential mortgages”—mortgages that satisfy agency-prescribed underwriting standards. No credit risk retention is required if the underlying assets are qualifying residential mortgages or certain other obligations insured or guaranteed by the federal government or a GSE.<sup>311</sup>

The OCC, along with five other federal agencies, has issued a rule implementing section 941.<sup>312</sup> Residential mortgage securitizations must comply with the rule as of December 24, 2015. Other securitizations have until December 24, 2016, to comply. Among other things, the rule defines “qualified residential mortgage” as a “qualified mortgage” under section 129C of the Truth in Lending Act and its regulations. Also, for commercial loans, commercial real estate loans, and

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<sup>311</sup> 15 USC 78o-11(e)(3).

<sup>312</sup> OCC et al., “Credit Risk Retention,” 79 Fed. Reg. 77602 (December 24, 2014) (codified at 12 CFR 43).

automobile loans that satisfy the rule’s underwriting criteria, the risk retention requirement for securitization of those loans is decreased.<sup>313</sup>

Risk retention creates strong incentives for financial institutions to properly underwrite the loans and other assets that they securitize. Federal banking entities are unable to make low-quality loans with the expectation that they can securitize and sell all of the risk to investors. Consequently, federal banking entities are encouraged to originate loans and other assets with lower credit risk. Thus, risk retention should decrease the likelihood of a buildup of poorly underwritten or poorly structured mortgages, which contributed to the 2008 financial crisis.

### *Volcker Rule*

The Volcker Rule restricts proprietary trading in securities, including structured products that are securities. In addition, the rule’s prohibition on having an ownership interest in a covered fund applies to certain asset-backed securities. Many securitization vehicles rely exclusively on section 3(c)(1) or section 3(c)(7) of the Investment Company Act to avoid registering as an investment company. These vehicles are covered funds unless they qualify for an exclusion. Furthermore, an asset-backed security could be an ownership interest. Whether it is depends on the specific features of the instrument. Finally, the Volcker Rule’s prohibition on entering into covered transactions with certain funds prevents federal banking entities from offering structured investment vehicles, the kinds of liquidity support that created unexpected risks in 2008.

For a full discussion of the Volcker Rule, see “Securities—Risk mitigation—Volcker Rule.”

### *Enhanced Capital Standards*

The OCC’s enhancements to capital standards apply to structured products. For a summary of the enhancements, see “Derivatives—Risk mitigation—Enhanced capital standards.”

### *Removal of Credit Ratings*

Ending federal banking entities’ exclusive reliance on credit ratings should help them better understand the risks in their investment portfolios and make investment decisions that are better informed. For a full discussion of this topic, see “Securities—Risk mitigation—Removal of credit ratings.”

## **Recommendations**

### *Address Concentrations of Mark-to-Model Assets and Liabilities*

Many structured products have no ready market price and are difficult to value. In the absence of market prices, federal banking entities rely on pricing models to mark structured products. Under relevant accounting principles, many of these products are marked to fair value each day,

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<sup>313</sup> See 12 CFR 43.15.

creating price risk. The OCC has 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 assumptions. Federal banking entities with concentrations of mark-to-model assets or liabilities raise supervisory concerns because the subjectivity inherent in valuing mark-to-model positions makes it difficult to assess their true risk profile and consequently their capital adequacy.<sup>314</sup> The OCC will propose guidance or a rulemaking to address the potential risks posed by concentrations in mark-to-model assets and liabilities. For example, the OCC could develop a rule or guidance that (1) directs federal banking entities to have robust oversight programs to control the size and scope of their portfolio of mark-to-model assets and liabilities throughout the economic cycle and (2) clearly articulates the remedial actions that the federal banking entity must take when it develops concentrations of mark-to-model assets and liabilities that exceed its risk tolerances.

### *Reconsider Allowing National Banks to Purchase Asset-Backed Securities as Type III Securities*

The OCC is considering not allowing national banks to hold as Type III securities asset-backed securities, which may be backed by bank-impermissible assets. 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 permissibility of investments in asset-backed securities by reference to the underlying assets, as is the case with Type V securities. 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, including

- securities guaranteed by the federal government, a state government, a municipality, or a GSE.
- investment-grade small-business-related securities, investment-grade commercial-mortgage-related securities, and investment-grade residential-mortgage-related securities.
- investment-grade marketable securities backed by a pool of loans and in which a national bank could invest directly.

Historically, most mortgage-backed securities have been Type I, IV, or V.

As with any amendment to 12 CFR 1, the OCC will solicit public comment on this change via a *Federal Register* notice of proposed rulemaking. The OCC will consider comments and publish any amendments to its regulations.

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<sup>314</sup> One set of researchers concludes that investors value level 3 assets at a discount to reported fair value, particularly during financial crises. Beng Wee Goh et al., "[Market Pricing of Banks' Fair Value Assets Reported Under SFAS 157 Since the 2008 Economic Crisis](#)," 34 *J. Account. & Pub. Pol'y* 129 (2015), (finding a discount of 21 percent during 2008 and 12 percent during 2011).

## *Reconsider Allowing Federal Savings Associations to Purchase Asset-Backed Securities as Corporate Debt Securities*

The OCC is considering not allowing federal savings associations to hold as corporate debt securities asset-backed securities, which may hold federal savings association-impermissible assets. The OCC's concern is the same as its concern for allowing national banks to hold asset-backed securities as Type III securities: assessments of asset-backed securities' credit quality depend heavily on the underlying assets. Federal savings associations would be unable to buy asset-backed securities under HOLA section 5(c)(2)(D) and 12 CFR 160.40, but they could invest in asset-backed securities under other authority.<sup>315</sup> For example, they could purchase GSE-guaranteed mortgage-backed securities under HOLA section 5(c)(1)(F).

### **Conclusion**

The financial crisis of 2008 showed that certain federal banking entity activities were far more risky than believed. Congress responded by restricting some of these activities and imposing structural reforms that substantially mitigate the risks of other activities. For example, requiring swap margin (whether bilateral or through a central clearinghouse) significantly mitigates the credit risk from swap dealing. Other risks remain, however, which is why the OCC plans to

- issue a proposed rule to prohibit federal banking entities from holding asset-backed securities that hold bank-impermissible assets.
- address concentrations of mark-to-model assets and liabilities with a rulemaking or guidance.
- clarify minimum prudential standards for certain national bank swap dealing activities.
- consider providing guidance on clearinghouse memberships.
- clarify regulatory limits on physical hedging.
- address national banks' authority to hold and trade copper.
- incorporate the Volcker Rule into the OCC's investment securities regulations.

The OCC's regulatory initiatives therefore build upon the many statutory reforms to enhance federal banking entities' safety and soundness.

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<sup>315</sup> See, e.g., 12 USC 1464(c)(1)(F) (GSE-guaranteed securities).

# Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act



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