The Federal Banking Agencies' Report on Activities and Investments of Banks and Nonbank Affiliates

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Yesterday, the Federal Reserve, OCC and FDIC issued the long-expected report to Congress and the FSOC, as required under section 620 of the Dodd-Frank Act, regarding activities and investments of banks and their nonbank affiliates, which were defined collectively in the report as "banking entities" (the "620 Report"). In addition to a comprehensive review and discussion of currently-permissible activities and investments of banking entities, that **107-page document** includes a discussion by each agency of associated risks, applicable risk mitigation activities and legal limitations, and specific recommendations. Below are our initial takeaways from the 620 Report. We will circulate a more comprehensive analysis next week.

Federal Reserve makes recommendations while OCC makes proposals. The surprising call by the Federal Reserve for an outright repeal of the merchant banking authority dominated the initial headlines, as it probably should have, but the recommendations and actions of the OCC, while likely to garner less press, do not require Congressional action and have a more imminent impact. The OCC has already issued a **proposed rule** to prohibit certain commodity activities of national banks. This will also affect state-chartered banks that rely on state "wild-card" statutes to engage in the same activities as national banks.

Federal Reserve recommends that Congress repeal certain statutory exemptions and authorities. After focusing its review and discussion on activities and investments authorized in 1999 pursuant to the Gramm-Leach-Bliley Act (*i.e.,* those permissible only for a financial holding company), the Federal Reserve recommended the outright repeal of several of these exemptions and authorities without any empirical cost-benefit support.

Specifically, the Federal Reserve recommended that Congress repeal:

- the statutory merchant banking authority;
- the grandfathering exemption under section 4(o) of the BHC Act for certain companies that became financial holding companies after 1999;
- the statutory provision that exempts corporate owners of industrial loan companies from the regulatory and supervisory framework applicable to bank holding companies; and
- the statutory exemption for grandfathered unitary savings & loan holding companies from the activities restrictions applicable to other savings & loan holding companies.

While the recommendation to repeal merchant banking authority, like all of the Federal Reserve's recommendations, requires Congressional action to implement, the Federal Reserve also noted that it is currently considering regulatory measures that would limit what it termed "safety and soundness risks of merchant banking investments."

The Federal Reserve provided no rationale for its recommendation beyond restating its concerns about "tail risk" for potential environmental liabilities in the event that the merchant banking authority were used to invest in a portfolio company engaged in environmentally sensitive commodities activities ***and*** the portfolio company's corporate veil were pierced ***and*** the shareholders were held liable for the acts of the portfolio company. It seems odd to base such a sweeping recommendation on such a narrow rationale. It is like saying Congress should repeal the authority to make loans because borrowers might default. After 15 years of experience with merchant banking investments, it seems extraordinary that the Federal

Reserve would make such a sweeping recommendation that will adversely affect the ability of nonfinancial companies, especially small and medium-sized businesses, to obtain financing in the form that is most useful to them, without solid empirical evidence that the activity is per se unsafe and unsound for the nonbank affiliates that are eligible to exercise the merchant banking authority. It is important to emphasize that insured banks and the deposit insurance fund are ring-fenced against the risks of merchant banking investments by a variety of measures, including the fact that neither insured banks nor any of their subsidiaries are permitted to make merchant banking investments themselves, and insured banks and their subsidiaries are insulated from the risks of their nonbank affiliates by sections 23A and 23B of the Federal Reserve Act.

FDIC takes a "wait and see" approach. In contrast to the Federal Reserve, the FDIC elected to take what amounts to a "wait and see" approach by indicating it plans to (1) review activities related to investments in other financial institutions and other equity investments, as well as to (2) determine whether the prudential conditions and standards under which the FDIC will evaluate filings under its part 362 need to be clarified with respect to activities and investments of state non-member banks involving mineral rights, commodities or other "non-traditional activities."

OCC makes changes. The OCC specifically rejected making any recommendation regarding legislative action. However, in contrast to the FDIC's general "wait and see" approach, the OCC identified a number of specific "potential enhancements" regarding regulations and "certain precedents" that merit reconsideration or clarification. These include a number of actions that the OCC itself plans to take without the need to wait for or defer to Congress, including:

- issuing a proposed rule restricting national banks and federal savings associations from holding as Type III securities asset-backed securities that may be backed by bank-impermissible assets;
- addressing concentrations of mark-to-model assets and liabilities whether by rule or guidance;
- clarifying minimum prudential standards for certain swap dealing activities;
- considering guidance on national banks' ability to be members of clearinghouses;
- clarifying regulatory limits on physical hedging;
- addressing national banks' authority to hold and trade copper; and
- incorporating the Volcker Rule into the OCC's Part 1 investment securities rules.

While not part of the 620 Report, earlier this year the OCC removed from its public website the cumulative list of activities permissible for national banks as an "outdated publication." That cumulative list included a number of interpretations related to activities and investments on which the OCC made recommendations in the 620 Report, including derivatives, physical commodities, securities and structured products.

What's next?

This is perhaps the biggest unknown, although for reasons as different as the individual paths chosen by each regulator in the 620 Report.

- Federal Reserve. As noted above, the Federal Reserve's recommendations require action by Congress, and most likely a future Congress, which is always an uncertain proposition. It is also unclear, with respect to merchant banking authority, what regulatory measures the Federal Reserve might implement even without Congressional action, such as increased capital requirements or quantitative limits for certain investments. Any change to that regulation would be required to be done jointly with the U.S. Department of the Treasury and Treasury has yet to issue any statements regarding the 620 Report.

- FDIC. The FDIC's wait and see approach means that little can be known now about that regulator's views on what specific changes or shifts, if any, it may view as appropriate.
- OCC. The OCC has long been viewed, almost since its establishment, as a champion of the statutory authority of national banks to engage in a broad range of activities that are part of or incidental to the business of banking. While some of the recommendations in the 620 Report represent a significant departure from this long-standing tradition, it remains to be seen the degree to which the OCC is willing to fundamentally change its history and ultimately act to restrict or remove the ability of national banks to engage in activities that the OCC itself has previously interpreted to be part of the business of banking or incidental to it.

Regardless of the three different regulator approaches, the 620 Report and its recommendations raise the specter of a retrenchment in the permissible activities of banks and the ability of their nonbank affiliates to provide capital demanded by the real economy.

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