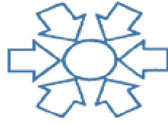

FedFin Client Report

Wednesday, September 14, 2016

Agencies Launch Full-Bore Attack on Non-Traditional Activities

Client Report: **CHARTER23**

Executive Summary

In this report, we provide an in-depth analysis of last week's inter-agency report on bank and BHC structure. Generally perceived as an FRB attack on merchant banking, we conclude that both the FRB and OCC, and to a lesser extent also the FDIC, have now agreed upon a campaign to expunge non-traditional activities from banking organizations even if an activity is well-captured by current prudential rules and has evidenced no high-risk characteristics. This critical and dramatic policy change – one reason we are told that the report is more than four years overdue – has sweeping implications across the range of M&A opportunities as well as for the manner in which banks of all sizes will be able to take on innovative operations in the fintech arena. Non-banks looking for bank charters along the lines contemplated last year by PayPal will also face significant obstacles in light of the new inter-agency policy.

In addition to these strategic implications, the inter-agency policy will spark strong political push-back. Banks are already mobilizing resources to prevent Congress next year from acting on the FRB recommendation that merchant banking be banned for FHCs. Firms contemplating industrial loan company (ILC) charters for non-traditional services will similarly battle the FRB's call on Congress while the few powerful, grandfathered SLHCs will demand to hold on to powers the FRB now also asks Congress to strip away.

The new regulatory agenda also will require policy and political advocacy at the agencies and whatever Administration takes hold. The FRB does not need Congress to curtail merchant banking through new capital rules and little-noticed plans by the OCC for new rules on permissible bank investments will also have a chilling effect on merchant banking as well as possibly constrain market-making and structured-investment products.

Because the FDIC has taken a far less-hostile stand on ILCs than the FRB, companies interested in this charter may well also try to get them while the getting is good. Importantly, the FRB's new, strong stand against non-traditional activities

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generally does not lump insurance and securities into the sanctioned sectors. However, we believe the FRB's policy rationale for sanctions – the need for a level playing field and indirect risks to affiliated banks – will nonetheless drive its thinking on M&A and prudential rules.

Analysis

Each of the agencies provided its own section, an unusual approach to an inter-agency report reflecting not only different jurisdictions, but also different points of view.

1. FRB

The FRB's report returns the FRB to its longstanding position – waived during much of the Greenspan era – in favor of strict limits between banking and commerce in all of the holding-company structures under its purview. Arguing that this would create a level playing field, the FRB also notes the risks of commercial activities (e.g., inability to offer objective financial services, concentration) and the limits of its prudential standards to address them. Some of these issues were cited in the FRB's ANPR on physical commodities (see FSM Report **COMTRADE4**) and will be echoed in forthcoming action here, but the sum total of them in our view defines a new FRB approach to financial regulation that continues the push to simplifying GSIBs and subjecting them to very stringent regulation.

Key points emphasized by the FRB are:

- the importance of the post-crisis regulatory framework in addressing the risk of non-traditional activities;
- a high comfort level with insurance and securities activities, as well as with numerous non-traditional activities (e.g., certain energy services, prescription-drug management);
- the need for Congress to roll back the full range of FHC and grandfathered merchant-banking and investment activities; and
- the need also for Congress to conform ILC parent activities to those authorized for BHCs and for an end to grandfathered non-permissible activities at SLHCs.

As noted, it will take Congress to contain ILC and SLHC powers, but the FRB's newfound position will have a strongly chilling effect on any efforts for new ILC charters despite the end of the moratorium banning them put in place by Dodd-Frank (see FSM Report **FHC19**). Any fintech-focused national banks possible once

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the OCC completes its review (see FSM Report **FINTECH**) would also need to act strictly within the scope of activities deemed by the OCC to be part of the "business of banking" and otherwise outside the scope of FRB jurisdiction. As noted yesterday, Comptroller Curry has raised a series of concerns about such specialized charters that track the new interagency policy on non-traditional activities.

2. FDIC

The FDIC plans to:

- review its authorizing and supervisory process for non-traditional activities, focusing in particular on investments in other financial institutions and other equity investments. Actions here could have a chilling effect on merchant banking and similar activities in FDIC-regulated banks; and
- decide whether to issue a policy statement on continued non-member, state bank activities related to mineral rights, commodities, and other non-traditional activities. Again, this would reach to merchant banking along with physical commodities.

Importantly, the FDIC discussion also addresses ILCs. However, in sharp contrast to the FRB, the FDIC emphasizes the way it reviews ILC activities and insulates the insured depository from those of its parent. The statement also notes that only one non-bank bank failed during the financial crisis while many others stood firm. We believe this signals a more open-door policy to ILCs at the FDIC even though we continue to believe that *de novo* charters will face hard review.

As discussed below, the OCC is considering significant changes to certain national-bank activities. State-chartered, non-member banks in "wild-card" states that link permissible activities to those authorized for national banks could thus also be affected by any OCC changes.

3. OCC

The OCC's report focuses on:

- derivatives;
- physical commodities;

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- securities; and
- structured products.

Unlike the FRB, the OCC does not recommend statutory action. However, it plans to:

- propose a rule to limit holdings of ABS in otherwise-impermissible obligations (e.g., where holdings are above investment limits or in equities). Those related to the GSEs would not be covered due to relevant statute. The OCC is considering a simple prohibition on national-bank holdings of ABS invested in otherwise-impermissible securities found to meet investment-grade and liquidity criteria. Similar standards for federal savings association debt holdings are also under consideration. As noted, this would make it harder for national banks to support merchant banking in their FHCs and possibly also to undertake certain market-making activities. Structured-note positions could also face significant constraints with investment-banking and capital-markets consequences;
- address concentrations in mark-to-model assets and liabilities in a new rule or guidance. This could mandate additional risk management and demand express remedial action when concentrations occur;
- clarify prudential standards for certain swap-dealing activities such as commodity derivatives;
- consider issuing guidance on securities and commodities clearinghouse membership. Nothing is said of substance as to what the OCC might do, but we expect the agency to contemplate firewalls and other actions related to default-fund risks to protect the insured depository within a clearing bank/BHC;
- clarify limits on physical hedging to provide a prescriptive methodology to calculate limits;
- address national-bank authority related to copper related activities; and
- incorporate the Volcker Rule into the OCC's securities rule (a largely technical matter).

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