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Financial Institutions Regulation Group Client Alert: "Hey Agencies: If you are looking for recommendations to Congress, we have one for you – how about giving GSIB securities firms access to deposit funding?"

In the report (the "Report") released to Congress in September 2016 pursuant to Section 620 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[1] the Board of Governors of the Federal Reserve System (the "Federal Reserve") caught many market participants and observers by surprise with a broad set of recommendations to Congress to strictly limit the ability of financial holding companies ("FHCs") to make investments in non-financial companies. The Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC") also made recommendations in the Report, and the Federal Reserve and the OCC followed the Report closely with proposed rule filings that would limit the ability of FHCs and national banks to make certain investments in physical commodities and industrial and commercial metals, respectively.[2]

What seemed most surprising about the recommendations from the agencies is that they bore little relationship to the risks identified during the period immediately preceding and during the financial crisis. So, with a little creative license, we will reshape the task set by Section 620 of the Dodd-Frank Act and offer up our own recommendation to Congress.

BACKGROUND TO THE RECOMMENDATION

Throughout 2016, U.S. regulators placed an increased focus on the risks arising from the liquidity requirements of global banks. Earlier in the year, William Dudley, President of the Federal Reserve Bank of New York, gave a significant speech (the

[1] *Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act* (September 2016), *available at* https://occ.gov/news-issuances/news-releases/2016/nr-ia-2016-107a.pdf.
[2] *See* http://www.federalreserve.gov/newsevents/press/bcreg/20160923a.htm and https://occ.gov/news-issuances/news-releases/2016/nr-occ-2016-108a.pdf. The OCC subsequently finalized a portion of its proposal in late December 2016. *See* https://www.occ.gov/news-issuances/news-releases/2016/nr-occ-2016-161a.pdf.

"Dudley Speech") in which he focused on the connection between liquidity and financial stability, and noted that while the liquidity regulation of material financial institutions has improved since the financial crisis, "some significant gaps remain."[3]

During the same week, the Federal Reserve, the OCC and the FDIC issued for public comment a proposed rule to establish a net stable funding ratio ("NSFR") which would require that large banking organizations maintain stable sources of funding over extended periods of time.[4] The NSFR is intended to complement the already-in-place liquidity coverage ratio ("LCR"), which requires large banking organizations to hold quantities of high quality liquid assets necessary to cover their expected funding needs over a rolling 30-day measurement period.[5]

Previously, the Federal Reserve and the FDIC released findings from their joint review of the resolution plans of the eight domestic firms identified by the Federal Reserve as global systemically important bank holding companies ("GSIBs").[6] The agencies found that five of the plans were not credible, and identified weaknesses in two of the others. Many of the concerns identified by the agencies were related to deficiencies in liquidity. In reviewing the agencies' public comments, the American Banker published an article titled "It's the Liquidity, Stupid: Regulators to Big Banks," which noted that the agencies "were clearly concerned whether global banks can stock up on enough cash and highly liquid assets" to withstand a new financial crisis.[7]

All of this regulatory action related to short- and long-term bank liquidity has been designed to fill a major shortfall of GSIBs from the last financial crisis.[8] While many GSIBs were undercapitalized relative to the risk carried by their assets, the spectacular failures, near failures and governmental bailouts of the 2007-09 period were prompted almost entirely by the sudden withdrawal of market liquidity.[9]

Following the adoption of the Dodd-Frank Act and the issuance of numerous capital and liquidity rules, the GSIBs subject to U.S. supervision are universally considered to be in much stronger collective financial strength than they were on the eve of the financial crisis.

However, the complexity of the rules, and in particular the terms of the NSFR and the openness of the items discussed in the Dudley Speech, show that the agencies are far from satisfied that they have captured all of the material liquidity risks facing the GSIBs. In part, this dissatisfaction stems from the fact that the various entity types

[3] *See* https://www.newyorkfed.org/newsevents/speeches/2016/dud160501.

[4] *See*, e.g., http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160503a1.pdf.

[5] 12 C.F.R. Part 249 (2016).

[6] *See* http://www.federalreserve.gov/newsevents/press/bcreg/20160413a.htm.

[7] *See* Lalita Clozel, American Banker, *It's the Liquidity, Stupid: Regulators to Big Banks* (May 2, 2016).

[8] *See* Leaders' Statement, G-20 Pittsburgh Summit, September 24-25, 2009, at paragraph 13, *available at* https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

[9] *See, e.g.*, http://www.bankofengland.co.uk/publications/Documents/news/2012/cr1plenderleith.pdf (discussing the run on the British bank Northern Rock in 2007 and the Bank of England's subsequent provision of emergency liquidity support) and https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr389.pdf (discussing the conditions precipitating the collapse of Bear Stearns and Lehman Brothers).

that form a GSIB are forced to fund themselves in materially different ways, even if they face largely the same risks. While commercial bank subsidiaries of GSIBs can accept deposits, which are generally considered the safest, most stable source of funding, other non-bank finance subsidiaries are forced to rely on non-deposit market-based funding strategies, all of which carry various forms of increased risk. In particular, securities firms were shown to be particularly susceptible to runs on their non-deposit funding arrangements.

THE RECOMMENDATION

At their heart, the LCR, NSFR and other liquidity countermeasures proposed and implemented by the regulators attempt to close this dichotomy, from non-deposit to deposit funding. And these steps have done an admirable job. However, the Dudley Speech and the American Banker article, among other market commentary, clearly show that concern about this funding stability gap remains. So here is our recommendation: why not just change the law to permit securities firm subsidiaries of GSIBs to accept deposits?

I first wrote on this issue back in 2008 when I analyzed the difference in market treatment of the near failure of Bear Stearns and of Countrywide.[10] Why are deposits a better liquidity option? Deposits[11] provide banks with an extremely liquid source of short-term funding, and because of deposit insurance, largely remove the credit risk of the issuing bank for depositors. This makes it very easy for banks to raise funding, even in a malfunctioning market. In fact, sometimes in markets where non-deposit markets such as commercial paper or repurchase agreement financing stop functioning as expected, investors will instead move their funds to deposits until markets normalize.

Compare then the funding options for a securities firm subsidiary of a GSIB as opposed to a commercial bank subsidiary of a GSIB. While both entities engage in a variety of financial activities (which may be somewhat overlapping – lending/prime brokerage, custody, trust services, underwriting of bank-eligible securities, financing of treasury securities and similar activities), the securities firms do not have the same governmental insurance backstop for their short-term funding obligations, and therefore run the risk that counterparties will discontinue funding them at any time and for any reason, as was the case in 2008.[12]

There may have been good and valid reasons for mandating this distinction in funding in 1932, but such reasons seem trivial in 2016 when compared with the potential for systemic risk disruption resulting from the failure of a securities firm subsidiary of a GSIB.

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[10] *See* "What is a Deposit and Should Securities Firms be Able to Accept Them?", *Douglas Landy et al* (on file with author) (May 1, 2008); "Bear Stearns v. Countrywide", *Douglas Landy* (on file with author) (May 1, 2008).

[11] The FDIC provides deposit insurance covering the depositors of a failed FDIC-insured depository institution, up to certain limits. The standard insurance deposit limit is $250,000 per depositor, per bank, per ownership category. *See* 12 C.F.R. Part 330.

[12] The Securities Investor Protection Corporation ("SIPC") provides insurance to brokerage account holders if a brokerage firm is a SIPC member that can cover certain credit losses. *See* http://www.sipc.org/about-sipc/introduction.

WHAT WOULD NEED TO BE DONE TO PUT THE RECOMMENDATION IN PLACE?

Generally speaking, there are two methods by which securities firm subsidiaries of GSIBs could receive the benefits of deposit funding: one that requires Congressional action and one that does not. The first method, which would be to permit such firms to receive deposits directly, would require a modification to a longstanding provision of the depression-era Glass-Steagall Act. The Glass-Steagall Act's best known purpose was to separate commercial banking from investment banking activity, both by preventing nonbanks from accepting deposits and by prohibiting banks from engaging in certain securities activities and affiliating with securities firms.[13] While this era of separation is generally considered to have ended in 1999 when the Gramm-Leach-Bliley Act ("GLBA") repealed key provisions of the Glass-Steagall Act,[14] it is important to note that the GLBA did not repeal the Glass-Steagall Act in its entirety. Rather, the GLBA deleted sections 20 and 32 of the Glass-Steagall Act, which had prohibited banks from affiliating with securities firms and from having director and personnel interlocks with those firms.[15]

Sections 16 and 21 of the Glass-Steagall Act, in contrast, remain in place to this day. Section 16 limits the scope of a bank's permissible securities activities, while section 21 makes it a criminal act for any person or entity that is not a bank to receive deposits.[16] Therefore, while GLBA allowed banks and securities firms to affiliate with one other, it left in place the strict separation between the *activities* permitted to a bank and those permitted to a nonbank, and the separation of the methods by which each type of entity may fund itself. As a result, Congress would need to amend or repeal section 21 in order for a non-bank such as a securities firm to be able to accept deposits without being considered to have committed a criminal act.

But Congressional action may not be the only potential solution. What if non-bank subsidiaries of GSIBs could accept deposit-like instruments that were as liquid as deposits but not actually deposits under federal law? There may be numerous types of instruments that meet the above criteria, but there is actually one is used by banks presently: credit balances. Agency offices of foreign banks are not permitted under federal law to accept deposits (much like securities firms) but have the same liquidity demands as do branch offices of foreign banks and many U.S. banks.[17] Instead, if permitted under applicable State law, they are allowed to accept credit balances. A credit balance must (i) arise out of, or be incidental to, a lawful banking power, (ii) serve a specific purpose, (iii) not be solicited from the general public, (iv) not be used to pay routine operating expenses, (v) be withdrawn within a reasonable period of time related to their purpose, and (vi) be drawn in a manner reasonably related to the size and nature of the account.[18] If credit balances work for agency offices (and for commercial lending companies[19]), why wouldn't they work for securities firms? And

[13] Banking Act of 1933, Pub. L. No. 73–66. The "Glass-Steagall Act" generally refers to §§ 16, 20, 21 and 32 of the Banking Act of 1933.
[14] Financial Services Modernization Act of 1999, Pub. L. No. 106–102, 113 Stat. 1338.
[15] *Id*.
[16] *See* Glass-Steagall Act §§ 16 and 21.
[17] As of June 2016, there were 35 agency offices of foreign banks in the U.S., with approximately $136 billion of assets funded through credit balances and other sources. https://www.federalreserve.gov/releases/iba/201606/bytype.htm.
[18] *See* 12 C.F.R. § 211.21(b).
[19] *Id*. at (g).

we suspect there are other types of deposit-like, non-deposit instruments that could be used to shore up the liquidity position of these firms.

The other, quicker method by which the Federal Reserve could allow securities firm subsidiaries to receive the benefit of deposit funding is by waiving key restrictions imposed by Section 23A of the Federal Reserve Act[20] and its implementing regulation, Regulation W.[21] Section 23A places various restrictions, quantitative limits, and collateral requirements on "covered transactions" between an insured bank and its affiliates, and has the effect of severely restricting the ability of banks to fund their nonbank affiliates. The purpose of these restrictions, as described by the Federal Reserve, are "(i) to protect against a depository institution suffering losses in transactions with affiliates; and (ii) to limit the ability of a depository institution to transfer to its affiliates the subsidiary arising from the institution's access to the federal safety net."[22] Short-term securities financing transactions would be covered transactions under the Dodd-Frank Act amendments to Section 23A.[23]

However, in times of market stress, these restrictions may run counter to the overarching goal of financial stability. Section 23A allows the Federal Reserve to grant waivers, by regulation or order, from the requirements of Section 23A "if [the Federal Reserve] finds such exemptions to be in the public interest and consistent with the purposes of Section 23A."[24] From 2007 to 2009, in response the financial crisis, the Federal Reserve did just that: over those three years, the Federal Reserve granted a significant number of temporary waivers from the requirements of Section 23A to various banks, allowing those banks to provide funding to their securities affiliates for the purpose of bolstering liquidity in certain markets.[25] These waivers, though nominally at odds with Section 23A's stated goal of limiting the ability of depository institutions to transfer the subsidy associated with the federal safety net to their affiliates, were granted for the purpose of supporting market liquidity and were found by the Federal Reserve to be in the public interest.[26] The provision of Section 23A allowing for such waivers was subsequently amended by Section 608 of the Dodd-Frank Act, which provides that exemptions from the requirements of Section 23A can be vetoed by the FDIC within a 60-day window if the FDIC finds that such exemptions create unacceptable risks to the Deposit Insurance Fund. Section 608 of the Dodd-Frank Act further provides that national banks may be granted exemptions from Section 23A if the Federal Reserve and the OCC agree that they are in the public interest and the FDIC does not object. A similar procedure is provided for State non-member banks.

[20] 12 U.S.C. § 371c.

[21] 12 CFR Part 223.

[22] *See* 67 Fed. Reg. 76560 (Dec. 12, 2002).

[23] Section 608 of the Dodd-Frank Act.

[24] 12 U.S.C. § 371c(f)(2); 12 C.F.R. 223.43.

[25] *See, e.g.*, Letter from Robert deV. Frierson, Deputy Secretary of the Board, to Bank of America Corporation (Aug. 20, 2007). A full list of these waivers is available on the Federal Reserve's website at https://www.federalreserve.gov/boarddocs/legalint/federalreserveact/2007/ (issued in 2007), https://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2008/ (issued in 2008) and https://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2009/ (issued in 2009).

[26] *Id*.

CONCLUSION

While regulatory reforms such as the LCR and NSFR have attempted to shore up the liquidity risks faced by GSIBs, it is clear that gaps still remain. Banks and their securities affiliates, both part of the same GSIB holding company structure and subject to many of the same risks, must fund themselves in drastically different ways. In the depths of the last financial crisis, the Federal Reserve found a way to alleviate certain market disruptions by allowing banks to transfer the benefits of deposit funding on a temporary, limited basis to their securities affiliates. As we look to the years ahead, it is perhaps time to consider whether a more permanent solution should be in order.

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