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The ABCs of Banking Law

Activity and Investment Limitations

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Overview of the Regulatory Structure

Charter Type	Primary Regulator	Secondary Regulator(s)	All Banks & Holding Cos.
National Bank	OCC		CFPB
State Member Bank	State Chartering Agency	Fed	CFPB
State Non-Member Bank	State Chartering Agency	FDIC	CFPB
Federal/State Savings Banks	Fed - OCC State - State Chartering Agency	State - FDIC	CFPB
Bank Holding Company	The Fed regulates as an umbrella supervisor		CFPB
Financial Holding Company	The Fed regulates as an umbrella supervisor		CFPB
Nonbank SIFIs	The FSOC will designate who these SIFIs are, and the Fed will oversee		CFPB

Activities Permissible for National Banks



National Bank Act 12 U.S.C. § 24 (Seventh):

All such incidental powers as shall be necessary to carry on the business of banking;

- by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt;
- by receiving deposits;
- by buying and selling exchange, coin, and bullion;
- by loaning money on personal security; and
- by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes. . . .

Activities Permissible for National Banks



Judicial Expansion of the “bank powers” clause:

- “incidental powers necessary” to carry on the business of banking (*Arnold Tours, Inc. v. Camp*, 472 F.2d 427 (1st Cir. 1972))
 - “*Convenient or useful*” in connection with performance of established activity pursuant to an express power
- “business of banking” not limited to express powers (*Nations Bank of N.C. v. Variable Annuity Life Ins. Co.*, 251 U.S. 251, 258 (1995))
 - The business of banking includes brokerage of financial investment instruments such as annuities.

Regulatory Expansion: OCC Interpretations



- Regulatory Expansion: OCC Interpretations
 - Interpretive expansion by Chief Counsel Julie Williams (1995):
- “[A] developmental and organic relationship exists between the business of banking and activities incidental thereto”
 - “functional equivalent” or “logical outgrowth”
 - benefits customers or convenient/useful to banks
 - involves similar risks to those taken by banks before
 - within the overarching concern for safety and soundness
 - role of technology necessitates development

Regulatory Expansion: OCC Interpretations



- Over time, can evolve from *incidental* to part of the *business of banking* itself because of the close relationship.
- Comptroller has compiled a list of activities permissible to national banks and federal savings associations. OCC, Activities Permissible for National Banks and Federal Savings Associations Cumulative (Oct. 2017)

Activities Permissible for State Banks



- State statute
- FDICIA (1991) limited state bank powers to national bank powers, except for
 - Agency activities (e.g., Real Estate Brokerage)
 - FDIC authorized principal activity after finding
 - No risk to the deposit insurance fund and
 - Bank is adequately capitalized

Core Banking Services



- Making loans (including products that are the functional equivalent of a loan, such as financing leases)
- Accepting deposits
- Negotiating notes and drafts (i.e., cashing checks)
- Foreign exchange operations
- Trust and fiduciary services
- Custodial services
- Credit intermediation (i.e. derivatives)
- Payment and Settlement services
- Financial data processing

The ability to hedge and manage risks related to permissible activities are deemed incidental activities.

Future innovations and technology. Cryptocurrencies?

Insurance Activities



- National Bank Act Sec. 92: national banks located in a place with *less than 5,000* people may sell insurance *as agents* for a fee
 - But may sell insurance (annuities) *nationwide*, as long as their insurance office is located in a “less than 5,000” place
- Generally, banks *may not underwrite insurance* directly
 - Except for certain insurance products underwritten prior to 1999 (Gramm-Leach-Bliley Act) – mainly, credit-related

Real Estate Activities



- **Real-estate lending** (commercial and residential)
 - 12 U.S.C. § 371 – authority to make loans secured by real estate
 - Trading mortgage loans and mortgage-backed securities
- **National Bank Act Sec. 29** prohibits national banks from holding real estate, except for certain specified purposes.
 - **Key exceptions:**
 - Foreclosure on a debt in satisfaction of debt previously contracted (DPC property)
 - Premises and related properties (but subject to regulatory approval if the investment exceeds a bank's capital)
 - Public-welfare investments
 - **Noteworthy OCC Interpretations (2005):**
 - May build and own hotels, condominiums, and a windmill farm

Investment and Securities Activities



- Glass-Steagall Act of 1933 – Wall between traditional and investment banking, but
- Gramm-Leach-Bliley Act of 1999 – permit affiliations between traditional banks and investment banks within a “financial holding company” (FHC) structure. Securities “push out”-a bank may not do activities that would cause it to be a securities broker or dealer except for identified banking products.
- National Banks may be government and municipal securities dealers.
- Dodd-Frank Act of 2010 – Volcker Rule
 - Prohibits “banking entities” from (1) “proprietary trading” and (2) investments in private equity/hedge funds
 - Important exceptions—
 - Underwriting
 - Market-making
 - Risk-mitigating hedging
 - De minimis investments in private equity/hedge funds

Bank Investments in Securities



- A Bank may invest in certain debt securities for its own account (12 CFR 1).
- Banks may invest, deal and underwrite without limit in Type I securities: US Treasury and agency securities, municipal securities and other obligations backed by the full faith and credit of the United States.
- Banks may invest in Type III “investment securities” that are both investment grade and marketable. This includes corporate bonds and non-US sovereign bonds. Exposure limit of 10% of the bank’s capital per obligor.
- Banks may invest in Type IV mortgage-backed securities without limit.
- Banks may invest in Type V asset-backed securities that are investment grade and marketable. Exposure limit of 25% of the bank’s capital per issuer.
- Reverse Repurchase Agreements. OCC interpretation relies on OCC Part 1 rather than general lending authority.

Bank Subsidiaries



- **Operating Subsidiary** – limited to activities of bank parent (other than accepting deposits)
 - National bank, 12 U.S.C. § 24(7); 12 C.F.R. § 5.34;
 - -State bank, state law and 12 U.S.C. § 1831a
- **Minority Equity Investments** – limited to activities of the bank parent.
 - -National Bank, 12 C.F.R. § 5.36.
- **Financial Subsidiary** – may engage in more activities than bank parent, but fewer activities than subsidiary of a financial holding company
 - -Created in GLBA (1999)
 - -Financial in nature and incidental to any activity that is
 - financial in nature, but NOT insurance underwriting or
 - merchant banking
 - -National bank, 12 U.S.C. § 24a; 12 C.F.R. § 5.39.
 - -State bank, 12 U.S.C. § 1831w
- **Service Corporation**
 - -Bank Service Corporation Act, 12 U.S.C. §§ 1861-67

Activities Permissible for Bank Holding Companies (BHCs)



- Bank Holding Company Act of 1956 (BHCA) – Section 4(c)(8), 12 U.S.C. § 1843(c)(8), 12 C.F.R. § 225.28 – key permissible non-banking activities (“closely related” to banking)
- Federal Reserve’s Regulation Y – parameters of non-banking power, deemed “frozen” after the Gramm-Leach-Bliley Act of 1999; now represents full extent of BHC-permissible activities

Core Banking Services and Beyond



- Extend Credit
- Service Loans
- Any activity related to extension of credit
 - Real estate and personal property appraising
 - Commercial real estate financing
 - Check-guaranty service
 - Collection agency and credit bureau services
 - Asset management, servicing and collection
 - Acquiring debt in default
 - Real estate settlement servicing
- Control of non-bank depository institutions – e.g. industrial banks and savings associations

Insurance Activities



- 1982 – Garn – St Germain – Insurance activities are NOT closely related to banking
- Limits to ability to sell as agent or broker
- May not engage in underwriting activities
 - Except where primarily related to an extension of credit

Real Estate Activities

- Leasing personal and real property
- All real estate activities permitted by depository subsidiaries
- Prohibited from providing brokerage or agency services

Investment and Securities Activities



Financial and Advisory Services

- Investment advisor to qualified investment companies
 - Publish general financial information and advice
 - Provide specific advice in connection with mergers, acquisitions, buyouts
 - Provide educational courses and materials to consumers
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- **Role in Investments**
 - Agents in transactional services by providing brokerage services
 - Buy/sell securities in secondary market on order
 - “riskless principal”
 - Agent for private placement of securities
 - Futures commission merchant
 - **Volcker Rule**
 - Prohibited from proprietary trading or hedge fund sponsorship & management
 - Various exceptions (see above)

BHC Equity Investing



- A BHC may acquire for investment purposes shares of any company up to 5% of a class of voting securities and 33% of total equity. No holding period limitations. 2 U.S.C. § 1843(c)(6)
- Other equity investments in companies engaged solely in permissible activities. 12 U.S.C. § 1843(c)(8); 12 U.S.C. § 1843(k).
- Beware of the Federal Reserve “Control Rule”. 12 C.F.R. § 225.

Supplemental and Service Activities



- Management Consulting and Counseling
 - Employee benefits and human resources consulting
 - Management training and career counseling
- Logistical Services
 - Courier services
 - Commercial papers
 - Documents, other written instruments
 - Printing and selling checks
- Issue and sell money orders, savings bonds, traveler's checks
- Data Processing
- Community Development

Activities Permissible for Financial Holding Companies



- Creation of Financial Holding Company (FHC) structure with enactment of Gramm-Leach-Bliley Act (1999)
 - FHCs are well-capitalized and well-managed BHCs with depository institutions that are well-capitalized and well-managed and with CRA ratings of Satisfactory or above that make an election
- FHCs may engage in activities that are
 - “financial in nature,”
 - “incidental to a financial activity,” or
 - “complementary to a financial activity” if does not pose a substantial risk to safety or soundness of depository institutions or financial system

Activities Designated as “Financial in Nature”

12 U.S.C. § 1843(k)(4)

- Insurance underwriting
- Insurance agency and brokering
- Securities underwriting
- Securities brokerage
- Activities closely related to banking
- Activities permissible for BHCs outside of US
- Merchant banking (passive investments)

- Cryptocurrencies?

Merchant Banking Investments



- Equity investments in any commercial company (up to 100%)
- Passive investment with no routine management
- 10 year holding limit (15 for private equity funds)
- No cross marketing with the bank
- Reg W affiliate presumptions at 15% ownership.

Other “Financial In Nature” Activities



- Process to consider new activities financial in nature, incidental, or complementary, 12 U.S.C. § 1843(k)(2)
 - Finder activities as incidental to a financial activity, 12 C.F.R. § 225.86(d)
 - Real estate brokerage and investment management – never acted upon
 - Trading in physical, nonfinancial commodities (oil, gas, agricultural commodities) as complementary to the financial activity of trading commodity derivative products

Volcker Rule



- Potentially most impactful on FHC's investment and securities powers (broadest powers)
 - Same restrictions as for depository institutions and affiliates
 - Potential restructuring of FHC's business activities
 - How Volcker Rule has affected merchant banking investments or commodities trading