

Authority of Service Corporations of Federal Savings Associations to Underwrite and Deal in Municipal Securities

Summary Conclusion: A federal savings association's service corporation may underwrite and deal in securities of states and their political subdivisions. Such activities are "reasonably related to the activities of financial institutions," and therefore are permissible, subject to certain supervisory restrictions.

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Subjects: Home Owners' Loan Act/Savings Association Powers

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any state or political subdivision, without limitation,³ and subsidiaries of national banks have been permitted to underwrite or deal in municipal bonds.⁴ In addition, a number of states, including [State A], have enacted statutes authorizing a state-chartered depository institution or its subsidiary to engage in the proposed underwriting and dealing activities.

The Savings Bank has established a department to provide both banking and financial advisory services to [State A] municipalities. With respect to its banking services, it is the primary depository bank for [] local government entities and has a significant depository relationship with [] others. With respect to financial advisory services, the Savings Bank's department advises [] municipal clients on issues regarding borrowing, debt policies and capital improvement programs. Through the Service Corporation, a registered broker-dealer with the Securities and Exchange Commission (SEC) and the state of [State A], the Savings Bank provides brokerage and investment advisory services. The Savings Bank believes that the Service Corporation's underwriting and dealing in securities of states and their political subdivisions will enhance the Savings Bank's relationship with existing customers, attract new customers, and allow the Savings Bank to compete with national banks and many state banks, including [State A]-chartered banks, who are permitted to provide these services.

The Savings Bank has significant experience in providing financial advisory services to [State A] municipalities with respect to the issuance of general obligation and municipal revenue bonds. Employees of the Savings Bank would provide support for the municipal securities underwriting and dealing activities by the Service Corporation, either as dual employees or through an operating agreement. In addition, the Service Corporation will hire additional employees with experience in such activities.

Under the proposal presented, the Service Corporation would underwrite and deal in municipal securities that are either investment grade, carry municipal bond insurance, or otherwise meet the Service Corporation's established underwriting standards, subject to any limitations or restrictions imposed by OTS. The Service Corporation will act as sole underwriter on small issues and as a member of an underwriting syndicate for larger issues. The Service Corporation will offer the municipal securities to three target groups: (i) institutional customers of the Savings Bank, (ii) retail customers of the Savings Bank and Service Corporation, and (iii) to the extent permitted by OCC regulations and [State A] law, fiduciary accounts of [] (Trust Company), a national bank subsidiary of the Savings Bank.

The Savings Bank and the Service Corporation will comply with the Interagency Statement on the Sale of Nondeposit Investment Products and the National Association of Securities Dealers, Inc.'s (NASD) Rule 2350, which imposes requirements on the operations of a broker-dealer on the premises of a financial institution. Accordingly, the Service Corporation will disclose to customers that the municipal securities being offered for sale are not insured by the FDIC; are not deposits or other obligations of the Savings Bank and are not guaranteed by

³ See 12 C.F.R. §§ 1.3(a) and 1.2(i)(4) (2001).

⁴ See OCC Conditional Approval No. 309 (April 12, 1999); OCC Conditional Approval No. 297 (Dec. 8, 1998); OCC Corporate Decision No. 98-48 (Oct. 20, 1998); and OCC Conditional Approval No. 262 (Dec. 11, 1997).

the Savings Bank; and are subject to investment risk, including possible loss of the principal invested.

In addition, the Service Corporation will disclose any involvement in the underwriting of the securities, and comply with the Municipal Securities Rulemaking Board's (MSRB) Rule G-23, which establishes disclosure requirements for broker-dealers when affiliates act as financial advisors to issuers of municipal securities underwritten by the broker-dealer. Accordingly, the Service Corporation will disclose the Savings Bank's role as a financial advisor for a particular security when offering that security to customers.

The Savings Bank also will comply with the other applicable requirements of the OTS regulations on subordinate organizations, 12 C.F.R. Part 559, such as restrictions on owners and state of incorporation, and limitations on the Savings Bank's investment in Service Corporation to 3 percent of the Savings Bank's assets, with any amount over 2 percent of assets limited to investments for community, inner city, or community development purposes.⁵

The Service Corporation is a registered broker-dealer with the SEC⁶ and a member of NASD and MSRB. Therefore, it is subject to the financial reporting, anti-fraud, and financial responsibility rules applicable to broker-dealers, as well as the rules of the MSRB and oversight by the NASD.

The Savings Bank has identified underwriting risk, credit risk, market risk, and operational risk as the primary risks of the proposed activities. To mitigate such risks and to ensure that the proposed activities will be conducted in a safe and sound manner, the Service Corporation, as stated in its business plan, will: (i) initially act as sole underwriter on small issues and as a member of an underwriting syndicate for larger issues, limiting its exposure to any one offering, (the Service Corporation will increase its participation level only after its customer base increases and it proves its ability to place its allotments); (ii) primarily underwrite and deal in securities of [State A] municipalities, which the Service Corporation has noted have an above average credit quality; (iii) only acquire municipal securities that are investment grade, carry municipal bond insurance or otherwise meet the Service Corporation's established underwriting standards, subject to any limitations or restrictions imposed by OTS; (iv) have a bond portfolio of high credit quality, good liquidity, and short duration, establishing a maximum portfolio and mark to market on a daily basis; and (v) utilize experienced Savings Bank employees, either as dual employees or through an operating agreement, as support for the proposed activities, and hire additional employees, as needed, with the requisite experience in such activities.

⁵ The Savings Bank and Service Corporation will also be subject to the loans to one borrower limitations. See 12 U.S.C. § 1464 (u) and 12 C.F.R. §§ 559.3(k)(2) and 560.93 (2001).

⁶ We do not address the permissibility of the proposed activities in an entity that is not a registered broker-dealer with the SEC.

II. Discussion

We discuss below whether the underwriting and dealing in general obligation and municipal revenue bonds and municipal notes of states and their political subdivisions is a permissible activity for a service corporation of a federal association, and whether there are any supervisory or safety and soundness reasons to limit or refuse to permit the investment.

A. Permissibility

Service corporation subsidiaries of federal associations may engage in the pre-approved activities listed under 12 C.F.R. § 559.4, and federal associations may request approval for service corporations to engage in any other activity “reasonably related to the activities of financial institutions.”⁷ Engaging in underwriting and dealing in securities of states and their political subdivisions is not pre-approved under 12 C.F.R. § 559.4. Accordingly, service corporations of federal associations may engage in such activity only after receiving OTS approval.

There are no specific criteria for determining whether an activity is reasonably related to the activities of financial institutions. In adopting a somewhat different “reasonably related” standard, the Federal Home Loan Bank Board (FHLBB) suggested that the regulation allows broad discretion in determining the nature and scope of activities that are “reasonably related.”⁸ Typically, OTS has approved an activity on “reasonably related” grounds because it is linked to an established financial institution activity or a pre-approved activity. Recent opinions have focused on the nature and purpose of the activity and the kind of risk it presents.⁹

Neither OTS nor its predecessor, FHLBB, has previously considered whether the underwriting and dealing in securities of states and their political subdivisions are permissible activities for a service corporation. In this instance, however, there are two factors, the nature and purpose of underwriting and dealing activities, and the type of risk it presents, that lead us to conclude that there is an adequate legal basis for OTS to determine that permitting the Service Corporation to engage in underwriting and dealing in securities of states and their political subdivisions is “reasonably related to the activities of financial institutions.”

First, with respect to the nature of the proposed activities, both national banks and certain state-chartered depository institutions and their subsidiaries may engage in the proposed underwriting and dealing activities. With respect to national banks, Congress has provided explicit statutory authority for well-capitalized national banks to underwrite, and deal in

⁷ See 12 C.F.R. § 559.3(e)(2)(ii) (2001). Section 5(c)(4)(B) of the Home Owners’ Loan Act (HOLA), 12 U.S.C. § 1464(c)(4)(B), which authorizes federal associations to invest in service corporations, does not limit the types of activities in which such entities may engage.

⁸ A predecessor service corporation regulation, 12 C.F.R. § 545.9-1 (1971), permitted “such other activities ... as the [FHLBB] may approve upon application therefore.” 35 Fed. Reg. 10751, 10752 (July 2, 1970). In 1973, the FHLBB added the “reasonably related” standard to “reduce the number of applications filed by deterring those involving non-related activities which in any case would not be approved.” 38 Fed. Reg. 24200 (Sept. 6, 1973).

⁹ See OTS Op. Chief Counsel (July 16, 1997) at 4; Legal Opinion (Business Transactions Division, May 7, 1997).

obligations (including limited obligation bonds, revenue bonds, and certain other obligations) of any state or political subdivision of a state, in essence providing that such activities are part of the "business of banking."¹⁰ The statute does not place explicit limitations on a national bank's ability to engage in such activities.

OCC's regulations historically have permitted national banks to underwrite or deal in general obligation bonds of any state or political subdivision, without limitation,¹¹ and allowed subsidiaries of national banks to underwrite or deal in municipal bonds.¹² The Gramm-Leach-Bliley Act (GLBA) eliminated OCC's ability to allow operating subsidiaries to engage in activities not permissible for national banks,¹³ but amended 12 U.S.C. § 24 (Seventh) to authorize well-capitalized national banks to underwrite and deal in municipal revenue bonds.¹⁴ On January 30, 2001, OCC issued a proposed rule that would implement the GLBA statutory revisions.¹⁵

In addition, at least 24 states, including [State A], have enacted statutes authorizing a state-chartered depository institution or its subsidiary to engage in the proposed underwriting and dealing activities. Seven additional states permit a state-chartered depository institution or its subsidiary to underwrite and deal in general obligation bonds, but not municipal revenue bonds.¹⁶

While we do not need to reach, in this opinion, whether HOLA would expressly authorize these particular activities, we do note that it allows federal associations to invest in, sell, or "otherwise deal in" investments in obligations issued by any State or political subdivision thereof.¹⁷ OTS regulations allow federal associations to "make, invest in, purchase, sell, participate in or otherwise deal in (including brokerage or warehousing) all loans and investments allowed under section 5(c) of the HOLA."¹⁸ Accordingly, dealing in municipal securities (including the proposed underwriting) might be construed as permissible under the express language of section 5(c)(1)(H) of the HOLA and 12 C.F.R. § 560.30.

Second, with respect to the risks of the proposed activities, they are similar to the risks borne by savings associations in making loans and holding investments. In connection with the underwriting activities, the Service Corporation may need to acquire and hold securities. In doing so, it would encounter credit risks analogous to normal lending operations because it

¹⁰ See 12 U.S.C. § 24 (Seventh).

¹¹ See 12 C.F.R. §§ 1.3(a) and 1.2(i)(4) (2001).

¹² See OCC Conditional Approval No. 309 (April 12, 1999); OCC Conditional Approval No. 297 (Dec. 8, 1998); OCC Corporate Decision No. 98-48 (Oct. 20, 1998); and OCC Conditional Approval No. 262 (Dec. 11, 1997).

¹³ See Pub. L. 106-102, Sec. 121, 113 Stat. 1338, 1373 (November 12, 1999), codified at 12 U.S.C. § 24a; 12 C.F.R. § 5.34(e).

¹⁴ See Pub. L. 106-102, Sec. 151, 113 Stat. 1338, 1384 (November 12, 1999), codified at 12 U.S.C. § 24 (Seventh).

¹⁵ See 66 Fed. Reg. 8178 (January 30, 2001).

¹⁶ See Conference of State Bank Supervisors, A Profile of State Chartered Banking, Seventeenth Edition (1998), at 126.

¹⁷ See 12 U.S.C. § 1464(c)(1)(H). The statute provides that a federal association may not invest more than ten percent of its capital in obligations of any one issuer, exclusive of investments in general obligations of any issuer.

¹⁸ See 12 C.F.R. § 560.30.

would hold municipal obligations that could present payment risk. It would also encounter market risk in underwriting and holding these securities. This risk is the same as that faced by savings associations, including the Savings Bank, that hold portfolios of investment securities, for which they experience, and manage, general market risk, including the risk that they may not be able to sell a security at an acceptable price, as a result of economic or other developments. In connection with its role as dealer in the proposed activities, the Service Corporation will encounter analogous market risks as a result of the short term holding of securities.

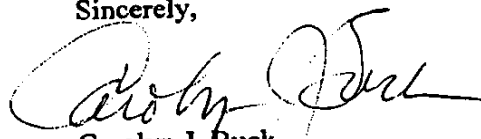
Based on the foregoing, in our opinion, the proposed activities are “reasonably related to the activities of financial institutions,” and are permissible for service corporations of federal associations. In reaching the foregoing conclusion, we have relied on the factual representations contained in the materials presented to us. Our conclusion depends upon the accuracy and completeness of those representations. Any material change in the facts or circumstances from those set forth in your submission could result in a different conclusion.

B. Supervisory Considerations

OTS may, at any time, limit a savings association’s investment in service corporations, or may limit or refuse to permit any activities of such entities for supervisory, legal, or safety and soundness reasons.¹⁹ We understand that the OTS [] Regional Office intends to send correspondence to the Savings Bank, under separate cover, to ensure that the Savings Bank operates the Service Corporation in a safe and sound manner, and that the proposed activities do not cause any supervisory concerns.

We trust that the foregoing has been responsive to your request. Any questions regarding this matter should be directed to Frances C. Augello, Senior Attorney, Business Transactions Division at (202) 906-6151.

Sincerely,



Carolyn J. Buck
Chief Counsel

¹⁹ See 12 C.F.R. § 559.1(a) (2001).