GIBSON DUNN

The U.S. Comptroller of the Currency Nominee and Her Writings: What They Mean for Banks and Fintechs

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On September 23, 2021, President Joseph Biden announced his intention to nominate Professor Saule Omarova of Cornell Law School to be the next Comptroller of the Currency. The Comptroller heads the Office of the Comptroller of the Currency (OCC), the Treasury bureau that supervises national banks and federal thrifts; the Comptroller is also an *ex officio* member of the Board of Directors of the Federal Deposit Insurance Corporation (FDIC).

If confirmed by the Senate, Professor Omarova will have significant influence over regulatory policy, not only for banking institutions, but also for fintech companies that seek to enter the banking system via either a national bank or FDIC-insured industrial bank charter or that have bank partners.

Professor Omarova worked in the Bush Treasury Department and has published numerous articles on financial regulation. This Alert touches on the key themes of her academic writings and addresses how these themes could translate into regulatory priorities at the OCC and FDIC, and in view of the fact that President Biden will likely soon nominate a new Vice Chair for Supervision at the Board of Governors of the Federal Reserve System (Federal Reserve).

A. Key Themes

Professor Omarova has written on numerous topics in her academic career. Early on, she analyzed 1990s OCC interpretations that expanded national bank derivatives activities to include derivatives on commodities and equities; the Federal Reserve's granting of Section 23A exemptions immediately before and during the 2008 Financial Crisis; and the historical exemptions from the definition of a "bank" under the Bank Holding Company Act.[1] More recently, she has written on bank governance, innovation in the financial industry, "culture" at financial institutions, restructuring the Federal Reserve to take customer demand deposits, and the "Too Big to Fail" problem, among other topics.[2]

Several key themes emerge from these writings:

- Concerns that post-Financial Crisis reforms have only magnified the size and interconnectedness of the largest banking organizations
- Concerns that banking and related financial activities frequently serve only private interests
- Concerns that activities outside of narrow banking – derivatives, commodities, trading, and even certain capital markets activities – are inherently risky
- Concerns that a focus on "innovation" may result in a weakening of supervisory standards

Perhaps most interesting, however, is Professor Omarova's recurring theme that traditional bank supervision is too narrowly focused on what she calls "micro" issues and solutions, and that a new regulatory paradigm centered on overall "macro" economic and public interest goals, and including substantially increased government intervention in the financial sector, may be needed.

1. Concern with Size and Interconnectedness

Professor Omarova, like other observers, has noted one of the ironies of post-Financial Crisis regulation – that although the size and interconnectedness of the global banking sector contributed significantly to the Crisis, the financial system was saved only by increasing the size of the nation's largest banks:

> The post-crisis increase in the level of concentration of the U.S. financial industry is difficult to deny. For example, as of the year-end 2017, top five U.S. bank holding companies (BHCs) held forty-eight percent of the country's BHC assets. By early 2018, there were four U.S. BHCs with more than $1.9 trillion in assets on their individual balance sheets. Despite the post-crisis passage of the Dodd-Frank Act, the most wide-ranging regulatory reform in the U.S. financial sector since the 1930s, [too big to fail] remains a "live" issue on the public policy agenda.[3]

This in turn, she believes, imposes considerable challenges for supervisors: "today's financial system is growing increasingly complex and difficult to manage. This overarching trend manifests itself not only in the dazzling organizational complexity of large financial conglomerates, but also in the exponential growth of complex financial instruments – derivatives, asset-backed securities, and other structured products – and correspondingly complex markets in which they trade."[4] The result is that it is "extremely difficult to measure and analyze not only the overall pattern of risk distribution in the financial system but also the true level of individual financial firms' risk exposure."[5]

2. Private Versus Public Interest

It is fair to say that Professor Omarova is not a strong believer in the "Invisible Hand." Her articles frequently posit a dichotomy between the driving forces of finance and the "public interest." Her article on bank culture, for example, makes this assertion:

> [New York Federal Reserve Bank President] Gerald Corrigan argued that, in exchange for the publicly-conferred benefits uniquely available to them, banks have an obligation to align their implicit codes – and their actual conduct – with the public good. In practice, however, there has been little evidence of such an alignment . . . . One of the most troubling revelations [about bank conduct before the Financial Crisis] was that, in the vast majority of these cases, banks' and their employees' socially harmful and ethically questionable business conduct was perfectly permissible under the existing legal rules. In each of those instances, bankers voluntarily, and often knowingly, chose to pursue a particular privately lucrative but socially suboptimal business strategy. And, as long as mortgage markets kept going up and speculative trading in mortgage assets remained profitable, bankers showed no interest in fulfilling their public duties or prioritizing moral values over pecuniary self-interest.[6]

In an article on bank governance, she returns to this theme, stating that "[a]ll too often, however, the incentives of bank managers and shareholders to pursue short-term private gains are perfectly aligned but work directly against the public interest in preserving long-term financial stability. The recent financial crisis . . . made abundantly clear that the modern system of corporate governance . . . is not a sufficiently reliable or consistent mechanism for managing this insidious and apparently pervasive conflict in a publicly beneficial way."[7]

Although it is clear how Professor Omarova views what then-Chief Judge Cardozo called "the forms of conduct permissible in a workaday world for those acting at arm's length,"[8] it is less clear how she defines the "public interest." Her writings do, however, suggest that it includes a focus on maintaining financial stability and appropriately allocating capital and credit to productive use, which she argues is not likely to occur absent government intervention:

> [T]o date, there has been no meaningful debate on improving the system-wide allocation of financial resources to productive enterprise. In most, if not all, post-crisis discussions on financial regulation, the underlying presumption remains that private market actors are inherently better at assessing financial risks and spotting potentially beneficial investment opportunities 'on the ground.' Accordingly, the existing dysfunctions in the process of system-wide credit allocation are framed predominantly in terms of specific private incentive misalignments or more general political-economy frictions.[9]

3. Preference for Narrow Banking

From her earliest writings, Professor Omarova has expressed a distrust of activities that are not at the core of traditional commercial banking. In an early article, she took issue with the OCC's increasingly flexible approach to interpreting the phrase "business of banking" in the National Bank Act to include derivative activities related to commodities and equities, including hedging such activities through physically settled transactions, and related activities such as national bank participation in power marketing and clearing organizations.[10] She similarly criticized Federal Reserve interpretations of the Gramm-Leach-Bliley Act under which commodity activities were deemed "complementary" to financial activities, and investments in commodity-related assets could be permissible merchant banking investments.[11] (It is worthwhile remembering that under Governor Daniel Tarullo, the Federal Reserve commenced an advanced notice of proposed rulemaking to consider established commodity activities by financial holding companies.[12]) And Professor Omarova strongly supported the statutory Volcker Rule but feared that the law's mandated administrative rulemakings had great potential to weaken it.[13]

These concerns about risks from non-traditional activities extend to capital markets activities generally, including those that were broadly permissible for bank holding companies even before the Gramm-Leach-Bliley Act was enacted. (By 1997, the Federal Reserve had interpreted the Glass-Steagall Act in a manner that posed few limits on corporate debt and equity underwriting and dealing, in addition to underwriting and dealing in bank-permissible assets.[14]) Professor Omarova states that "[i]n today's world, secondary markets in financial assets are far bigger, more complex, and more systemically important than primary markets. . . . It is not surprising, therefore, that today's secondary markets in financial instruments are the principal sites of both relentless transactional 'innovation' and chronic over-generation of systemic risk."[15] In criticizing the Federal Reserve's Section 23A exemptions granted during the Financial Crisis, she argued that "it is hard to deny that these extraordinary liquidity backup programs also functioned to prop up the banks' broker-dealer affiliates, which . . . were in the business of creating, trading, and dealing in securities that needed . . . financing and, as a result, had direct exposure to . . . highly unstable markets."[16]

4. Innovation as a Source of Risk

In contrast to former Acting Comptroller Brian Brooks, who encouraged financial innovation, most notably with respect to national charters for virtual currency companies, Professor Omarova has had a skeptical eye on the question. One of her early articles, as noted above, criticized the OCC for its interpretive approach with respect to equity and commodity derivatives:

> [T]he OCC's highly expansive interpretation of the "business of banking" . . . served to undermine the integrity and efficacy of the U.S. system of bank regulation. Through the seemingly routine and often nontransparent administrative actions, the OCC effectively enabled large U.S. commercial banks to transform themselves from the traditionally conservative deposit-taking and lending institutions, whose safety and soundness were guarded through statutory and regulatory restrictions on potentially risky activities, into a new breed of financial "super-intermediaries," or wholesale dealers in pure financial risk.[17]

This view carries over in later discussions of pre-Financial Crisis loan securitizations and credit default swaps, as well as fintech generally. Of the latter, Professor Omarova has written:

> By making transacting in financial markets infinitely faster, cheaper, and easier to accomplish, fintech critically augments the ability of private actors to synthesize tradable financial claims – or private liabilities – and thus generate new financial risks on an unprecedented scale. Moreover, as the discussion of Bitcoin and ICOs shows, new crypto-technology enables private firms to synthesize tradable financial assets effectively out of thin air. . . . The sheer scale and complexity of the financial market effectively "liberated" from exogenously imposed constraints on its growth will make it inherently more volatile and unstable . . . . The same factors, however, will also make it increasingly difficult, if not impossible, for the public to control, or even track, new technology-driven proliferation of risk in the financial system.[18]

5. The Futility of Bank Supervision

Perhaps most interestingly for someone who would be the lead supervisor of most of the nation's largest banks, Professor Omarova's writings show a decidedly pessimistic view of the effectiveness of financial regulation. She frequently points out the failures of what she terms "micro" entity-specific solutions to such risks, in order to argue in favor of a revised "macro," *i.e.*, far more fundamental and structural, approach. One example comes from her article on Too Big To Fail: "At the heart of the TBTF problem, there is a fundamental paradox: TBTF is an entity-centric, micro-level metaphor for a cluster of interrelated systemic, macro-level problems. This inherent conceptual tension between the micro and the macro, the entity and the system, frames much of the public policy debate on TBTF."[19]

Professor Omarova's "macro" approach includes suggestions of potential governmental interventions in the financial system on a scale unprecedented even in times of crisis – government "golden shares" in large financial companies that would allow the government to override management decisions to forestall a crisis,[20] Federal Reserve counter-cyclical intervention in a broader range of financial markets,[21] "public interest" guardians who would supplement regulatory bodies to correct the self-interest of the financial sector,[22] and a significant National Investment Authority to counteract the biases of the private investment community.[23] As Professor Omarova acknowledges, such measures would require new legislation, for which there does not currently appear to substantial appetite.

B. Consequences For Regulatory Priorities

What then do these themes likely foretell should Professor Omarova receive Senate confirmation? It is of course always a challenge to predict the future, and academic writing is frequently at its best when it seeks to challenge traditional paradigms and manners of thought. This said, it does seem that the following outcomes are certainly within the realm of possibility.

1. Size and Interconnectedness

The OCC currently supervises eight of the country's ten largest banks: JPMorgan Chase, Bank of America, Wells Fargo, Citibank, US Bank, PNC Bank, TD Bank, and Capital One, ranging from just under $400 billion in assets to over $3 trillion in assets. Some, but not all, of them also engage broadly in investment banking activities. The OCC also regulates many banks in the next asset tier below.

The OCC does not have any general authority to break up well-managed banks or to order them to cease activities, but it is not unusual for the OCC to adjust its supervisory approach based on the risk profile of an institution. What Professor Omarova might add to this traditional approach given her views of increasing systemic risk and the importance of the "macro" is a more holistic approach, in which not only will a particular institution's own risk profile determine its supervision, but also the perceived risks created by those institutions to which it is most connected. In addition, large banks that fail to meet supervisory expectations can face activities limitations; an early article by Professor Omarova analyzed the idea of requiring regulatory approval of complex financial products.[24]

Moreover, although mergers of bank holding companies must be approved only by the Federal Reserve, in many cases once the holding company merger has been approved, the parties seek to merge the subsidiary banks for efficiency reasons. If the resulting bank will be a national bank, the OCC must approve the transaction under the Bank Merger Act. The statutory factors that the OCC must consider are similar to those the Federal Reserve considers, but the OCC makes an independent decision. Many of the required factors relate to size – competitive effect, ability of management (including on integrating institutions), and financial stability.[25]

2. Private Interest Versus Public Interest

In terms of constraining what Professor Omarova views as the self-interest of the financial sector, it is noteworthy that the responsible agencies, including the OCC, have never completely finalized the executive compensation rulemaking required by Dodd-Frank, something to which SEC Chair Gary Gensler has recently called attention.[26] One of the more controversial aspects of the original rulemaking was the extent of permissible clawbacks of compensation, if actions by individual bankers ended up imposing losses on the financial institution involved. On this question, Professor Omarova's characterization of the "morals of the marketplace" could be significant.

Another means by which the bank regulators have sought to address privatizing gains and socializing losses since the Crisis is bank governance. The OCC's principal contribution in this regard is its Guidelines Establishing Heightened Standards for large national banks and federal thrifts, which impose a prescriptive approach to certain aspects of bank corporate governance.[27] These Guidelines were adopted as safety and soundness standards pursuant to Section 39 of the Federal Deposit Insurance Act, which gives the OCC the authority to issue orders for noncompliance, orders that may be enforced by the issuance of civil money penalties or in federal district court actions. The OCC could further strengthen these standards or take a more aggressive approach to enforcing them.

3. Narrow Banking

Historically, as Professor Omarova herself has noted, the OCC has been one of the most flexible agencies in its interpretations of its governing statute, the National Bank Act. Although certain of the activities that she has criticized for increasing systemic risk are conducted by bank affiliates, not all of them are: national banks conduct significant derivative activities, certain capital markets activities are bank permissible, and numerous bank activities implicate the broad definition of proprietary trading contained in the Volcker Rule. Even in the absence of revisiting, for example, the National Bank Act interpretations relating to permissible derivatives activities, the OCC has the authority to examine all national bank activities. Those banking institutions with substantial businesses in areas that Professor Omarova has characterized as non-core and risk-creating should therefore expect a much stricter supervisory approach. The Volcker Rule regulations, which as revised still invite significant supervisory discretion in practice due to the difficulty of distinguishing between prohibited trading and permissible activities like risk-mitigating hedging, could well see ramped up examination interest, and expectations of compliance programs could increase.

4. Innovation and Fintechs

There are currently several pressing fintech-related issues at the OCC. First is the question of whether the OCC will grant a national bank charter to a company that proposes to make loans but not take FDIC-insured deposits, and that is not a statutorily authorized national trust bank. The OCC has claimed the authority under the National Bank Act to issue such a charter, but it has not acted on one such application, and it has been sued in federal court by state banking supervisors who believe that granting such a charter goes beyond the business of banking in the National Bank Act. Professor Omarova's statements on the potential perils of innovation for supervisors and her general "public interest" concerns may well be relevant on this question.

Second, shortly before and just after President Biden was inaugurated, the OCC granted three trust company charters to digital currency companies, and issued a broad interpretation of permissible digital currency activities under the National Bank Act. The OCC is currently re-examining the bases for such charters, with Acting Comptroller Hsu expressing safety and soundness concerns over certain virtual currency activities. For Professor Omarova, virtual currencies and other digital assets are one of the areas where innovation is most likely to cause systemic risk.[28]

Third, Professor Omarova will be a voting member of the FDIC Board, which determines whether a state industrial bank may receive deposit insurance, and which also must approve any change of control transaction involving an FDIC-insured industrial bank. Under Chair Jelena McWilliams – but with a Republican-appointed Comptroller and Republican-appointed Director of the Consumer Financial Protection Bureau – the FDIC Board approved two such applications, one for Square and one for Nelnet. In one of her earliest articles, Professor Omarova analyzed the historical exemption for industrial banks in the Bank Holding Company Act,[29] and since that writing, Congress has refused to repeal the exemption, and the FDIC has finalized a framework for supervising the parents of industrial banks. It is certainly possible that given her preference was "narrow" banking, Professor Omarova would wish to see a linkage to traditional banking activities, with ancillary activities being preferable when conducted in an agency capacity, when considering such applications.

Finally, many fintechs operate via bank partnerships. Under the Trump Administration, the OCC issued fintech-friendly interpretations regarding the "true lender" and "valid when made" doctrines, which engendered opposition from consumer groups and certain state regulators and attorneys general. Congress used the Congressional Review Act this summer to void the "true lender" rule, but the "valid when made" interpretation remains. Professor Omarova's criticism of the elasticity of the OCC's interpretations of the National Bank Act on derivatives matters during the 1990s could extend beyond the derivatives area to bank-fintech partnership issues. Demonstrating a lack of increased risk to banks and the system from such partnerships, therefore, could become significant.

5. The Quarles/Brainard Divide – Likely Positioning

It is also important to note that Professor Omarova's appointment is not taking place in a vacuum. In several weeks, Vice Chair Randal Quarles's term as the Federal Reserve Governor in charge of bank supervision will come to an end, although a mere Governor Quarles could remain at the Federal Reserve for another decade. During the last four years, Vice Chair Quarles has shepherded through a number of "reforms to the reform" wrought by the Dodd-Frank Act. Many of the more important actions drew dissents from Governor Lael Brainard, who is one of the contenders to be Governor Quarles' successor. Of these actions, quite a few implicated rules promulgated by the OCC as well as the Federal Reserve:

- Loosening the regulatory restrictions of the Volcker Rule
- Tailoring capital and liquidity requirements for an institution's asset size and other factors, with institutions between $100 billion and $250 billion in assets particularly benefiting
- Reducing margin requirements for inter-affiliate uncleared swap transactions
- Proposing to reduce the enhanced supplementary leverage ratio for the largest banks and their holding companies

From her articles, Professor Omarova would appear to be decidedly in Governor Brainard's camp on these four issues.

Conclusion: The Limits of Bank Supervision and Regulation

In her writings, Professor Omarova is a strong proponent for government intervention in the financial system, and a skeptic of a light-touch supervisory approach. In this way, she is reminiscent of the first *de facto* Federal Reserve Governor for bank supervision, another banking law professor turned regulator, Daniel Tarullo. Governor Tarullo, of course, oversaw the implementation of a highly prescriptive top-down approach to bank supervision at the Federal Reserve, which even he noted in his "farewell address" may have gone too far in some areas, particularly for non-systemic banks.[30] Professor Omarova also has quite a bit in common with former FDIC Chair Sheila Bair, who herself was a professor of regulatory policy, was critical of bank derivative activities, and pushed the Collins Amendment to the Dodd-Frank Act because of her suspicions regarding internal bank financial models.

But it is also fair to say that neither Governor Tarullo nor Chair Bair appeared to have quite as skeptical views on the limitations of bank supervision and regulation as Professor Omarova. What will a proponent of a new paradigm approach to the American banking industry do in the absence of any legislative appetite for departing from the reigning paradigm since the New Deal?

This is perhaps the most difficult question of all to answer. A logical response, however, is that in those areas that are perceived to pose the greatest risk, such a proponent would double down on the supervisory tools that are currently available in order to counter perceived risks at inception. Large federal banking institutions that depart from core deposit and lending activities should therefore expect searching supervisory reviews of their non-traditional activities.

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[1] Saule T. Omarova, "The Quiet Metamorphosis: How Derivatives Changed the 'Business of Banking,'" 63 U. Miami L. Rev. 1041 (2009); Saule Omarova, "From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act," 89 N.C. L. Rev. 1683 (2011); Saule T. Omarova and Margaret E. Tahyar, "That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States," 31 Rev. Banking & Fin. L. 113 (2012).

[2] Saule T. Omarova, "Bank Governance and Systemic Stability: The 'Golden Share' Approach," 68 Ala. L. Rev. 1029 (2017); Saule T. Omarova, "New Tech v. New Deal: Fintech as a Systemic Phenomenon," 36 Yale J. on Reg. 735 (2019); Saule T. Omarova, "Ethical Finance as a Systemic Challenge: Risk, Culture, and Structure," 27 Cornell J.L. & Pub. Pol'y 797 (2018); Saule T. Omarova, "The 'Too Big to Fail' Problem," 103 Minn. L. Rev. 2495 (2019).

[3] "The 'Too Big to Fail' Problem," *supra* note 2.

[4] *Id.*

[5] *Id.*

[6] "Ethical Finance as a Systemic Challenge: Risk, Culture, and Structure," *supra* note 2.

[7] "Bank Governance and Systemic Stability: The 'Golden Share' Approach," *supra* note 2.

[8] *Meinhard v. Salmon*, 164 N.E. 528 (N.Y. 1928).

[9] Saule T. Omarova, "What Kind of Finance Should There Be?", 83 Law & Contemp. Probs. 195 (2020).

[10] "The Quiet Metamorphosis: How Derivatives Changed the 'Business of Banking,'" *supra* note 1.

[11] Saule T. Omarova, "The Merchants of Wall Street: Banking, Commerce, and Commodities," 98 Minn. L. Rev. 265 (2013).

[12] *See* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140114a.htm.

[13] Saule T. Omarova, "The Dodd-Frank Act: A New Deal for A New Age?", 15 N.C. Banking Inst. 83 (2011)

[14] *See* https://www.federalreserve.gov/boarddocs/press/boardacts/1996/19961220/ (increasing limit on bank ineligible revenues for Section 20 companies to 25 percent of total revenues).

[15] "What Kind of Finance Should There Be?", *supra* note 9.

[16] "From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act," *supra* note 1.

[17] "The Quiet Metamorphosis: How Derivatives Changed the 'Business of Banking,'" *supra* note 1.

[18] "New Tech v. New Deal: Fintech as a Systemic Phenomenon," *supra* note 2.

[19] "The 'Too Big to Fail' Problem," *supra* note 2.

[20] "Bank Governance and Systemic Stability: The 'Golden Share' Approach," *supra* note 2.

[21] "The 'Too Big to Fail' Problem," *supra* note 2.

[22] Saule T. Omarova, "Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation," 37 J. Corp. L. 621 (2012).

[23] Robert C. Hockett & Saule T. Omarova, "Private Wealth and Public Goods: A Case for a National Investment Authority," 43 J. Corp. L. 437 (2018).

[24] Saule T. Omarova, "License to Deal: Mandatory Approval of Complex Financial Products," 90 Wash. U. L. Rev. 63 (2012).

[25] 12 U.S.C. § 1828(c).

[26] Akayla Gardner & Ben Bain, "Wall Street Pay Clawback Rule to Get New Push at SEC," Bloomberg News (September 22, 2021).

[27] 12 C.F.R. Part 30 (Appendix D).

[28] "New Tech v. New Deal: Fintech as a Systemic Phenomenon," *supra* note 2.

[29] "That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States," *supra* note 1.

[30] *See* https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm.

The following Gibson Dunn lawyers assisted in preparing this client update: Arthur Long.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, the author, or any of the following members of the firm's Financial Institutions practice group:

Matthew L. Biben – New York (+1 212-351-6300, mbiben@gibsondunn.com)
Michael D. Bopp – Washington, D.C. (+1 202-955-8256, mbopp@gibsondunn.com)
Stephanie Brooker – Washington, D.C. (+1 202-887-3502, sbrooker@gibsondunn.com)
M. Kendall Day – Washington, D.C. (+1 202-955-8220, kday@gibsondunn.com)
Mylan L. Denerstein – New York (+1 212-351- 3850, mdenerstein@gibsondunn.com)
William R. Hallatt – Hong Kong (+852 2214 3836, whallatt@gibsondunn.com)
Michelle M. Kirschner – London (+44 (0) 20 7071 4212, mkirschner@gibsondunn.com)
Arthur S. Long – New York (+1 212-351-2426, along@gibsondunn.com)
Matthew Nunan – London (+44 (0) 20 7071 4201, mnunan@gibsondunn.com)
Jeffrey L. Steiner – Washington, D.C. (+1 202-887-3632, jsteiner@gibsondunn.com)

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