Collateralized Mortgage Obligations: Probing the Limits of National Bank Powers Under the Glass-Steagall Act

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In response to the stock market crash of 1929, Congress enacted the Banking Act of 1933.1 This legislation was intended to restore public confidence in banking,2 to ensure and maintain the economic stability of banks by prohibiting unsound and imprudent bank investments,3 and to prevent potential conflicts of interest between commercial and investment banks.4 Congress perceived the mingling of commercial banking and investment banking as a major cause of the crash.5 The obvious fear underlying Congress' action was that banks would be tempted to invest their own assets in frozen or imprudent stocks.6

Congress also perceived subtle hazards that could result from bank participation in securities underwriting and marketing activities.7 The Supreme Court has identified some of the hazards that Congress sought to avoid: that the bank's interest in selling stock might impair its judgment on making loans,8 or that the dual role of commercial and investment banking would

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1. Pub. L. No. 73-66, 48 Stat. 162 (1933). The American banking system is a dual banking system in that banks may choose to be chartered by a state or the federal government. Banks seeking a federal charter (national banks) must apply to the Office of the Comptroller of the Currency (OCC). National banks are required to be insured by the Federal Deposit Insurance Corporation (FDIC) and to become members of the Federal Reserve System. State banks are chartered by the state in which they are located. Depending on state law, a state bank may elect or be required to be FDIC insured. State chartered banks may or may not be members of the Federal Reserve System as a state member bank. Banks may be regulated to varying degrees by a combination of the Federal Reserve Board (FRB), OCC, FDIC, and state agencies. This Comment is primarily concerned with the OCC because it is the primary regulator of national banks. The FRB also regulates all banks that are members of the Federal Reserve System. This Comment will not address the status of collateralized mortgage obligations (CMOs) under state regulations.

2. See 75 Cong. Rec. 3962, 3963 (1932).


4. Id.

5. Id.

6. See Investment Co. Inst. v. Camp, 401 U.S. 617, 630 (1971). "Congress had in mind . . . the obvious danger that a bank might invest its own assets in frozen or otherwise imprudent stock or security investments." Id.

7. Id.

8. Id. at 631. "[T]he pressure to sell a particular investment and to make the affiliate
set the promotional interest of the investment banker against the obligation of the commercial bank to provide impartial investment advice.\(^9\) Congress responded to these fears by enacting the Banking Act of 1933 or the Glass-Steagall Act (the Act),\(^10\) which generally prohibits commercial banks from issuing, underwriting, or dealing in securities except as set forth in the Act.\(^11\)

Although the Glass-Steagall Act generally prohibits commercial banks from underwriting or dealing in securities,\(^12\) there are certain specific exceptions to the Act's broad limitations.\(^13\) For example, section 16 of the Act explicitly authorizes a national bank to underwrite, deal in, and purchase for its own account obligations of the Government National Mortgage Association (GNMA),\(^14\) the Federal National Mortgage Association (FNMA),\(^15\)

Collateralized Mortgage Obligations

These agencies are primarily involved in issuing, underwriting, and dealing in mortgage-backed securities (MBSs). Until 1983, most MBSs issued by these three agencies were pass-through or pay-through obligations. In June 1983, the FHLMC introduced collateralized mortgage obligations (CMOs), a type of mortgage-backed security. Since their introduction, CMOs have garnered an increasing share of

cate holder a proportional interest in the full principal amount of any foreclosed or liquidated mortgage loan regardless of the monies received. K. Lore, supra note 14, at 2-27.


17. MBSs are bonds whose payments are secured by a set of mortgages. See F. Fabozzi, The Handbook of Mortgage-Backed Securities 619 (1985).

18. In pass-through obligations, the agency, as issuer, passes on to its investors the monthly principal and interest payments made on the mortgage pool. Id. at 1-3, 102, 119-20. The pass-through represents the investors' beneficial ownership of a fractional undivided interest in the mortgage pool. Id. at 102. Pay-through bonds rely on the cash flow from a mortgage pool. Id. at 1-3, 159. The principal and interest payments on the underlying mortgages are used to pay interest and principal on the bonds. Id. The amortization payments on the pay-through bonds are generally paid quarterly or semiannually to investors while pass-through payments are generally made monthly. Id. at 119, 159.

19. CMOs (also known as Fast-Pay/Slow-Pay Bonds or Serialized Mortgage-Backed Securities) are bonds issued by “limited-purpose subsidiaries of investment banking firms, insurance companies, home builders, mortgage bankers, . . . savings and loan association[s] and commercial bank[s].” Id. at 86. Usually, an affiliate organization is set up, through which an indentured trustee issues the bonds. K. Lore, supra note 14, at 3-24. In case of default, recourse is taken against the affiliate whose assets consist of the underlying mortgages. F. Fabozzi, supra note 17, at 364. The bonds are serviced by a specific pool of similar mortgages grouped together into a multiclass prioritization structure of short, medium, and long-term maturities. Id. at 173. Payments made on the underlying mortgages are used to make monthly, quarterly, semiannual, or other payments on the bonds. Id. at 160. The exception to this format is the zero coupon CMO or accreting bond which, during a part of its life, accrues interest as increased principal rather than as cash paid to an investor. Id. at 177. A given class of bonds is not redeemed until all of the bonds of an earlier priority are redeemed. Id. at 173. This prioritization structure provides investors with a reasonable degree of certainty regarding the cash flow of their investment. Id. at 173, 364.

Proceeds from the sale of CMOs are used to finance future mortgages and other lending activities. “A bank generally uses cmos [sic] as a source of liquidity in conjunction with its ownership of mortgage assets; this enables an issuing bank to obtain funds for additional lending activities.” Letter from Robert L. Clarke, Comptroller of the Currency, to Sen. Alfonse M. D’Amato (June 18, 1986), at 1 (OCC response).
the market.\textsuperscript{20}

The early 1980's also marked another development in the MBS market. Before then, the GNMA, the FNMA, and the FHLMC had enjoyed a virtual monopoly on the secondary market in government-backed MBSs.\textsuperscript{21} In recent years, however, the private sector has become attracted to both the primary and secondary mortgage markets by the success of the government MBSs, including government CMOs, and the apparent demand potential for housing credit.\textsuperscript{22} New private sector issuers and investors in this market include savings institutions, commercial banks, FSLIC-insured mutual savings banks, state and local retirement funds and investment agencies, and private pension and life insurance funds.\textsuperscript{23} Investment banks are presently the dominant issuers, underwriters, and dealers of government-backed CMOs.\textsuperscript{24}

The success of these new government-backed CMOs\textsuperscript{25} has created great interest among banks in other securities backed by mortgages. Nevertheless, because CMOs appear to fall within the Glass-Steagall Act's definition of a security,\textsuperscript{26} there is a significant legal question as to whether these private

\textsuperscript{20} F. FABOZZI, \textit{supra} note 17, at 86.
\textsuperscript{21} K. LORE, \textit{supra} note 14, at 1-9 to 1-10 (1985).
\textsuperscript{22} \textit{Id.} at 2-38.
\textsuperscript{23} \textit{Id.}
\textsuperscript{24} \textit{Id.}
\textsuperscript{25} In the first nine months of 1986, there were 640 issues of CMOs, totaling $27.81 billion. This is double the $13.46 billion worth of CMOs sold in 1985. \textit{See Kreps, Salomon Brothers Leads Underwriters of Mortgage-Backed Securities for 1986, AM. BANKER,} Oct. 10, 1986, at 15. There were a total of $58 billion in MBSs sold in 1986; the 1985 total was $20.6 billion. \textit{Taylor, Salomon is Top Underwriter in '86; First Boston Corp. Comes in Second, BOND BUYER,} Jan. 5, 1987, at 3.
\textsuperscript{26} The Glass-Steagall Act does not explicitly define the term "security." In interpreting "securities" under the Act, the Supreme Court has looked to the definition of "securities" in other legislation passed at the same time and for purposes similar to the Glass-Steagall Act—primarily the Securities Act of 1933 definition. \textit{See Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.,} 468 U.S. 137, 150-52 (1984).

Section 2(1) of the Securities Act of 1933 defines a security as:

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, . . . or, in general, any instrument or instrument commonly known as a “security,” or any certificate of interest of participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.


The Supreme Court has defined an investment contract for purposes of the Securities Act as a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ." \textit{See}
CMOs also fall within the Act’s general prohibition on a bank’s underwriting and dealing in securities. In each of the last three Congresses, banks have sought explicit statutory authority to issue, underwrite, and deal in private CMOs; both those backed by a bank’s own mortgages (their own CMOs), and those backed by the mortgages of other financial institutions (third-party CMOs). Thus far, these legislative efforts have been


The Securities and Exchange Commission has stated that offerings for a whole or fractional interest in mortgages or deeds of trust frequently constitute an investment contract and, therefore, are considered a security within the meaning of the federal securities laws. Public Offering of Investment Contracts Providing for Acquisitions, Sale or Servicing of Mortgages or Deeds of Trust, 1 Fed. Sec. L. Rep. (CCH) ¶ 2755, at 2914-15 (Jan. 31, 1958). The Commission has defined 11 attributes which may give rise to the creation of an investment contract. These are:

(a) Complete investigation and placing service.
(b) Servicing collection, payments, foreclosure, etc.
(c) Implied or express guarantee against loss at any time or providing a market for the underlying security.
(d) Making advances of funds to protect the security of the investment.
(e) Acceptance of small uniform or continuous investments.
(f) Implied or actual guarantee of specified yield or return.
(g) Continual reinvestment of funds.
(h) Payment of interest prior to actual purchase of the mortgage or trust note.
(i) Providing for fractional interests in mortgages or deeds of trust.
(j) Circumstances which necessitate complete reliance upon the seller, e.g., great distance between mortgaged property and investor.
(k) Seller’s selection of the mortgage or deed of trust for the investor.

Id.

Each of these elements has a bearing on whether there is an investment contract. Id. at 2915. Because CMOs have many of these attributes, a CMO is likely to be considered a security under the Glass-Steagall Act.


The Banking Act defines an underwriter as any person who has purchased securities from an issuer with a view towards distribution, or who offers or sells securities for an issuer in connection with distribution. Id. § 77b(11). Underwriting is the process of issuing and initially distributing securities in an offering to the public. This is also commonly referred to as the “primary” market.

The Banking Act also defines a dealer as “any person who engages . . . as agent, broker, or principal, in the business of offering, buying, selling . . . or trading in securities . . . .” Id. § 77b(12). Dealing occurs in the “secondary” market and is carried on by persons who buy and sell securities as principal on exchanges and in the over-the-counter market. The secondary market can also involve the purchase and sale of securities, as agent, by brokers acting for their customers.

The secondary market enhances the primary market by creating liquidity and flexibility, thereby increasing the number of investors willing to purchase in the primary market and the price investors are willing to pay. This, in turn, increases the capital available to the housing industry. F. Fabozzi, supra note 17, at 15.

unsucessful. 29

As an alternative, banks have brought proposals for additional authority to underwrite and deal in private CMOs before federal regulatory agencies. 30 These regulatory efforts have been considerably more successful. Indeed, the Office of the Comptroller of the Currency (OCC) recently granted a national bank permission to issue, underwrite, and deal in CMOs created by the bank through a banking subsidiary. 31

This Comment will analyze whether, under present law, banks and banking affiliates have authority to issue, underwrite, and deal in their own and third-party CMOs. First, it will review relevant sections of the Glass-Steagall Act. It will then analyze the OCC's interpretation of the Act, as well as relevant case law. The Comment also will consider the policy question of whether banks should be allowed to deal in secondary mortgage markets, and will review proposed legislation in this area, making recommendations concerning that legislation. The Comment will conclude that banks have authority to issue and to underwrite, but not to deal in, their own CMOs. In addition, it will conclude that there is no present authority for banks to issue, underwrite, or deal in third-party CMOs. Finally, it will suggest that Congress should grant banks the authority to underwrite and deal in CMOs of both types.

I. NATIONAL BANKS AND THE GLASS-STEAGALL ACT

The Banking Act of 1933 was enacted to address the lack of investor confidence resulting from the stock market crash of 1929. 32 The four sections commonly referred to as the Glass-Steagall Act are contained within the Banking Act of 1933. 33 The Act generally provides for the separation of...
commercial and investment banking activities through a series of prohibitions.\textsuperscript{34} Section 16 generally prohibits national banks from conducting business in certain securities-related activities.\textsuperscript{35} Similarly, section 21 generally prohibits securities dealers from engaging in banking activities.\textsuperscript{36} “Affiliations”\textsuperscript{37} between organizations which deal in securities and member banks are generally prohibited under section 20 of the Act.\textsuperscript{38} Finally, section 32 prohibits interlocking directors, officers, or employees between organizations “primarily” engaged in securities underwriting and marketing and member banks.\textsuperscript{39}

Although the Act contains several prohibitions limiting a bank’s commercial and securities activities, exemptions are provided that lessen the impact of the prohibitions. The interpretation of the various prohibitions and exemptions provides a framework for analyzing the authority of banks to underwrite and deal in CMOs.

Section 16 of the Act grants national and state member banks “all such incidental powers as shall be necessary to carry on the business of banking.”\textsuperscript{40} In addition, it sets forth the specific activities in which banks may engage.\textsuperscript{41} Along with these specific grants of power, section 16 generally limits a bank’s authority to deal in securities. A bank is permitted to purchase and sell securities “without recourse [and] solely upon the order and for the account of customers.”\textsuperscript{42} Therefore, a bank generally may not purchase or sell securities for its own account.\textsuperscript{43} Consequently, section 16

\textsuperscript{34} 74 CONG. REC. 3962, 3963 (1932).
\textsuperscript{36} 12 U.S.C. §§ 378(a)(1) (1982); see infra notes 47-49 and accompanying text.
\textsuperscript{37} See infra text accompanying note 54 for a definition of the term “affiliation.”
\textsuperscript{38} 12 U.S.C. §§ 377 (1982); see infra notes 52-55 and accompanying text.
\textsuperscript{39} 12 U.S.C. § 78 (1982); see infra notes 56-59 and accompanying text.
\textsuperscript{40} 12 U.S.C. § 24 (Seventh). State member banks are governed by the same limitations and conditions as national banks are under § 16 with respect to the purchasing, underwriting, selling, and holding of investment securities and stocks. Id. § 335.
\textsuperscript{41} For example, in addition to the GNMAs, FNMA, and FHLMCs, discussed supra notes 14-16 and accompanying text, banks are permitted to underwrite, deal in and purchase for their own accounts obligations of the United States, general obligations of any state or local or political authority, and securities of certain organizations, such as the obligations of the Washington Metropolitan Area Transit Authority. 12 U.S.C. § 24 (Seventh).
\textsuperscript{42} Section 16 provides that “The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account . . . .” 12 U.S.C. § 24 (Seventh).
\textsuperscript{43} See id. The statute also provides that “the association shall not underwrite any issue of securities or stock; Provided. That the association may purchase for its own account invest-
generally prohibits banks from underwriting or dealing in securities.  

Section 16, however, does contain certain exceptions to the general rule against underwriting or dealing in securities. The section 16 prohibitions do not apply to, *inter alia*, "obligations, participations or other instruments of or issued by the [FNMA] and the [GNMA], or mortgages, obligations, or other securities which are or ever have been sold by the [FHLMC]." Therefore, banks and, indirectly, their affiliates are affirmatively granted the power to underwrite and sell CMOs guaranteed by the GNMA, the FNMA, or the FHLMC under section 16 of the Act.  

Of equal importance is section 21 of the Act, which makes it unlawful for a bank to engage in the business of issuing, underwriting, selling, or distributing securities while also participating to any extent in the business of receiving demand deposits. Yet this section expressly provides that it does not affect the right of financial institutions to deal in, underwrite, purchase, sell, or otherwise engage in the business of investing in, or originating or participating in, investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulations prescribe." *Id.* (emphasis in original). The standards for such investments are set forth in 12 C.F.R. § 1 (1986). Because this authority does not permit underwriting or dealing, it is not considered further in this Comment.  

45. *Id.* The statute provides that "[t]he limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to . . . obligations, participations, or other instruments of or issued by the Federal National Mortgage Association, or the Government National Mortgage Association, or mortgages, obligations or other securities which are or ever have been sold by the Federal Home Loan Mortgage Corporation . . . ." *Id.*  

46. *Id.* Under operating Subsidiaries, 12 C.F.R. §§ 5.34(c) and 5.34(d)(2), an operating subsidiary of a national bank is regulated by the same rules and regulations as the parent bank and consequently can engage in the same practices of the parent bank. The relevant part of § 5.34(c) reads: "A national bank may engage in activities which are a part of or incidental to the business of banking by means of an operating subsidiary corporation." In order to so apply, the parent company must own at least 80% of the voting stock of the corporation. 12 C.F.R. § 5.34(c) (1986). The relevant part of § 5.34(d)(2) reads: "Unless otherwise provided by statute or regulation, all provisions of Federal banking laws and regulations applicable to the operations of the parent bank shall be equally applicable to the operations of its operating subsidiaries." 12 C.F.R. § 5.34(d)(2)(i) (1986). State member banks are granted the same authority as national banks pursuant to 12 U.S.C. § 335 (1982). Section 335 of title 12 reads: "State member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks under paragraph 'Seventh' of section 24 of this title." 12 U.S.C. § 335.  

47. The statute provides that it is unlawful: For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a
or sell investment securities or issue securities to the extent permitted under
section 16. For this reason, section 21 is generally considered to be "coex-
tensive" with section 16.

Section 21 also contains an important affirmative power—a clause permit-
ting banks "to sell, without recourse or agreement to repurchase, obligations
evidencing loans on real estate." The legislative history of the Glass-Steag-
gall Act demonstrates that Congress intended for banks to continue selling
mortgages without recourse.

Additionally, section 20 of the Act prohibits a Federal Reserve member
bank from affiliating with a corporation "engaged principally in the issue,
flotation, underwriting, public sale, or distribution" of securities. Although Congress failed to define the term "engaged principally" in the
statute, the Supreme Court has interpreted the phrase by examining the stat-
utory definition of "affiliation." Congress defined affiliation as (1) having
direct or indirect ownership or control of more than fifty percent of the vot-
ing stock of an organization; (2) having common ownership; or (3) having a

passbook, certificate of deposit, or other evidence of debt, or upon request of the
depositor . . . .


48. Section 21 provides in part that "the provisions of this paragraph shall not prohibit
national banks . . . from dealing in, underwriting, purchasing, and selling investment securities,
or issuing securities, to the extent permitted to national banking associations by the provisions
of section 16 of this title . . . ." Id.

137, 149 (1984) ("Because § 16 and § 21 seek to draw the same line . . . the underwriting
prohibitions described in the two sections are coextensive").

50. 12 U.S.C. § 378(a)(1). The statute provides in part that "nothing in this paragraph
shall be construed as affecting in any way such right as any bank, banking association, savings
bank, trust company, or other banking institution, may otherwise possess to sell, without re-
course or agreement to repurchase, obligations evidencing loans on real estate." Id.

51. [T]he provisions of section 21(a)(1) of the Banking Act of 1933, prohibiting
dealers in securities from engaging in the business of taking deposits, does not pre-
vent banking institutions from dealing in, underwriting, purchasing, and selling in-
vestment securities to the extent expressly permitted to national banks under the
National Banking Act and does not prevent banking institutions from selling mort-
gages without recourse.

Banking Act of 1935: Hearings Before the Subcomm. of the Senate Comm. on Banking and
Currency, 74th Cong., 1st Sess. 139 (1935) (statement of Mr. O'Connor, Comptroller of the
Currency) (emphasis added).

52. Section 20 provides in part that "no member bank shall be affiliated in any manner . . .
with any . . . organization engaged principally in the issue, flotation, underwriting, public sale,
or distribution . . . . of stocks, bonds, debentures, notes, or other securities . . . . ." 12 U.S.C.
§ 377. Section 20 also provides specific sanctions that the Federal Reserve Board may impose
at its discretion for violations, including fines of not more than $1,000 per day and the loss of
banking privileges. Id.

(1947).
majority of common directors. The Supreme Court has suggested that Congress therefore intended majority control in excess of fifty percent to be necessary before section 20's prohibition becomes effective. Notwithstanding the efforts of the Court to illuminate the meaning of "engaged principally" by analogy to the term "affiliation," neither Congress nor the Court has provided an exact definition.

Finally, section 32 of the Act prohibits any officer, director, partner, or employee of any organization "primarily engaged in the issue, flotation, underwriting, public sale, or distribution" of securities from serving at the same time in a similar capacity with a member bank. The Supreme Court has interpreted "primarily engaged" to include any firm whose underwriting business is substantial (and, therefore, primary), as opposed to the over fifty percent quantitative test of section 20. An exception to this general prohibition does exist. Section 32 authorizes the Board of Governors of the Federal Reserve System to allow cross-roles when, in the judgment of the Board, "it would not unduly influence the investment policies of [a] member bank or the advice it gives its customers regarding investments."

Viewed as a whole, the Glass-Steagall Act generally prohibits banks from directly underwriting and dealing in most securities. There are, however, important exceptions to these prohibitions that are crucial to the ability of banks to engage in CMO-related activities. The general prohibition, and these specific exceptions, are the framework within which the question of bank CMO activities must be analyzed.

55. See Agnew, 329 U.S. at 448.
56. Section 32 provides:
No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.
57. Agnew, 329 U.S. at 449.
58. Cross-roles refer to interlocks between officers, directors, or employees of an entity primarily engaged in securities and a member bank. See supra note 56.
II. AUTHORITY TO UNDERWRITE AND DEAL IN BANK'S OWN CMOs: THE LIBERTY NORSTAR BANK OF BUFFALO DECISION

The market for CMO's holds considerable potential. Consequently, banks want to be able to issue, underwrite, and deal in CMOs backed by the mortgages that they create, as well as CMOs backed by mortgages that are sold by other institutions, regardless of whether the mortgages are bank-eligibles. Bank eligibles are mortgages which banks are expressly permitted to issue, underwrite and deal in under the Glass-Steagall Act. Thus, despite the Act's general prohibition against banks' underwriting and dealing in securities, a strong financial incentive has prompted banks to seek such authority from the Office of the Comptroller of the Currency, the federal regulatory body that supervises national banks.

In April of 1985, the Liberty Norstar Bank of Buffalo applied to the OCC for permission to issue, underwrite, and deal in its own CMOs. The bank's proposal included the creation of a subsidiary, which through an indenture with a nonaffiliated trustee was to "issue bonds to be paid off in scheduled principal and interest payments at a fixed rate of interest." These bonds were to be collateralized by GNMA, FNMA, and FHLMC certificates and/or "nonfederally insured conventional residential mortgage loans," or any combination thereof.

Under the proposal, in the event of a default the trustee and/or bondholders would have recourse against the subsidiary, whose assets would consist solely of the collateral pledged to secure the bonds. A standard indenture would be executed in which the evidence of ownership of the underlying mortgages would be pledged to a trustee. Payments made on the certificates

60. For example, in 1985 there were 86 issues of CMOs worth $15.5 billion. See K. Lore, supra note 14, at 2-3 (citing Hustic & McDaniel, Major Developments in Housing and Mortgage Finance in 1985, Salomon Brothers Inc. Bond Market Res., Jan. 1986, at 13).
61. See supra notes 30-31 and accompanying text.
63. The bank's indenture with a nonaffiliated trustee was established under the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbb (1982 & Supp. III 1985). Proposal Letter, supra note 62, at 76,614. Thus, the record owner of the certificates is the indentured trustee even though the rights of the CMO holders are protected as if they were the owners of the loans.
64. Proposal Letter, supra note 62, at 76,614.
65. Id.
66. Id. at 76,715. No recourse would be had against the bank since the bank would not have reservable liability with the bond under Regulation D of the Board of Governors of the Federal Reserve, Reserve Requirements of Depository Institutions, 12 C.F.R. §§ 204.1 to 204.124 (1986).
and for the underlying mortgages would be received directly by the trustee as the record owner of the certificates. The trustee would reinvest accumulated underlying mortgage principal and interest payments until such time as they were to be distributed to the bondholders. The bank subsidiary then would be entitled to any monies still held by the trustee, free from any lien of the applicable indenture, after payments to the bondholders.

In response to Liberty Norstar's request, the OCC issued a brief interpretive "no-action" letter that stated that the OCC would not raise any objection to the bank or its subsidiary issuing, underwriting, or dealing in the bank's own CMOs as set forth in the proposal letter. The OCC based its conclusion on the facts and representations set forth in the bank's submitted opinions and supporting submissions: a June 10, 1985 telephone conversation between counsel for the bank, counsel for the Securities and Exchange Commission, and counsel for the OCC; and the legal opinion of the bank's counsel that the activities of the bank's subsidiaries would not violate federal banking law. The OCC no-action letter did not include any independent legal analysis.

Soon after the OCC decision, the Comptroller's Office received an inquiry from Senator Alfonse D'Amato regarding the Liberty Norstar decision. In a letter to the Comptroller dated June 3, 1986, Senator D'Amato, the Chairman of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, criticized the OCC's decision and raised concerns about the limited legal analysis contained in the OCC's no-action letter. Senator D'Amato requested that the OCC submit to the subcommittee the legal analysis not contained in the Liberty Norstar no-action letter.

The OCC consequently prepared a legal memorandum that set forth the reasoning underlying its Liberty Norstar decision. In that memorandum, the

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67. Until the payments were made to the bondholders, the interest profit would accrue to the bank. The trustee invests the funds, pending distribution to bondholders, in instruments permitted for the direct investment by banks in accordance with Banking Bulletin BB-83-58, at ¶ 49,102. See Proposal Letter, supra note 62, at 76,614-15.

68. Id.

69. A bank may request the OCC to rule on the application of the Act to securities which the bank holds or desires to purchase as an investment security for the bank, or which the bank holds or desires to deal in, underwrite, purchase, hold or sell as a security. Requests for Rulings, 12 C.F.R. § 1.9 (1986).

70. Proposal Letter, supra note 62, at 76,614.

71. Id.


73. Id.

74. Id.
OCC stated that the Liberty Norstar decision was based on a long line of OCC precedent recognizing the authority of national banks to transfer their mortgages and mortgage-related assets in transactions substantially similar to those proposed by Liberty Norstar. The OCC viewed a CMO broadly: as "a bond, or other obligation or evidence of indebtedness representing the transfer of an interest in an underlying mortgage, pool of mortgages or mortgage-related obligations." Based on this broad definition, the Comptroller argued that the transfer of a CMO by a bank could be characterized either as a sale of an interest in real estate or as a borrowing—both permissible activities under the Glass-Steagall Act.

A. Underwriting CMOs: Sale of an Interest in Real Estate

The OCC based its Liberty Norstar ruling in part on its 1977 Bank of America decision relating to pass-through obligations. In that decision, the OCC authorized Bank of America to sell pass-through participations in a pool of the bank’s mortgages which consisted of conventional real estate loans on single-family homes. The OCC based its decision on the section 21 proviso that allows for the sale, without recourse or agreement to repurchase, of obligations evidencing loans on real estate.

76. See id.
77. See id. Although the OCC mentioned that the transaction could be viewed as the receipt of deposits, nowhere in its decision did the OCC explain the theory or its application to the facts.
79. Id.
80. Id. Previous OCC interpretations of §§ 16 and 21 allowed national banks to repurchase and sell real estate loans, pass-through certificates representing real estate loans and bonds backed by real estate loans. Because it would be repurchasing and selling obligations evidencing loans on real estate, the bank would not be prohibited from selling CMOs, both eligible and ineligible, under section 21. See National Bank May Underwrite and Deal in Certain Mortgage-Backed Pass-Through Certificates, [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,421, at 77,543 (April 12, 1983) [hereinafter National Bank May Underwrite] (relying on a § 16 exemption which allows national banks to underwrite or deal in obligations insured by the Secretary of Housing and Urban Development, and § 21 which does not affect any other rights a bank may have "to sell without recourse or agreement to repurchase obligations evidencing loans on real estate."). This case is especially significant since it dealt with the purchase and sale of pass-through certificates in pools of mortgages, which were not originated by the bank, but rather were purchased by the trading bank. Id.; Bank of America, supra note 78, at 82,371 (allowing Bank of America to sell participations in pools of the bank’s mortgages). The Comptroller’s decision noted that the § 21 exemption for banks to sell without recourse or agreement to repurchase, underscored the “evident intent of Congress not to disturb the secondary market for real estate loans made by financial institutions.” Id.; see also
In the *Bank of America* decision, the OCC took the position that the pass-through participations were actually a sale of certain bank assets; specifically, conventional mortgage loans.\(^{81}\) In later decisions, the OCC expanded on this theory: where the participations are structured as pass-throughs, the participation holders have the same rights, liabilities and risks as if they owned the loans directly.\(^{82}\) Because of this structure, the OCC considers pass-throughs to be "legally transparent."\(^{83}\) Therefore, according to the Comptroller, because section 21 authorized national banks to purchase and sell real estate loans,\(^{84}\) national banks are also authorized to sell pass-through certificates representing a participation in a pool of such loans.\(^{85}\)

Thus, for purposes of the Glass-Steagall Act, the sale of the interests in pass-throughs did not alter the basic character of the transaction: the sale of assets from the bank’s mortgage-related portfolio.\(^{86}\) The OCC also concluded that the bank was not "in the business" of issuing or underwriting within the meaning of section 21 of the Act.\(^{87}\) The OCC noted that it was

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83. See generally *National Bank May Underwrite*, supra note 80, at 77,543.

84. See supra note 50.


86. See supra notes 81-83 and accompanying text.

87. See supra note 47.
doubtful that the issuance of nonrecourse, large denomination certificates backed by mortgages on a frequent basis, would be enough to demonstrate that the bank's subsidiary was engaged "in the business" of issuing or selling securities in the same sense as investment banking firms issue and sell securities. Consequently, the OCC ruled that Bank of America had authority under the Act to conduct its pass-through activities.

The OCC did not view the Liberty Norstar proposal as different in any material respect from Bank of America or similar OCC precedent. The CMOs to be issued by Liberty Norstar were backed by conventional mortgage loans and structured as pass-throughs. The holders of the certificates would have the same rights, risks, and liabilities as if they were the direct owners of the loans. Therefore, the OCC ruled that the CMOs were a permissible sale of the bank's assets that were designed in all material respects as a pass-through which had already been approved by the OCC.

The OCC relied on the legislative history of the section 21 proviso as additional support for the authority of banks to underwrite their own CMOs. The OCC has long held that section 21 authorizes national banks to purchase and sell real estate loans, as well as pass-through certificates representing such loans. Consequently, the OCC concluded that the sale

88. Bank of America, supra note 78, at 82,369.
90. Proposal Letter, supra note 62, at 76,615.
91. See supra note 82 and accompanying text.
93. See supra note 51 and accompanying text.
94. The proviso was intended to "increase the ability of the banks to serve their communities, to provide a greater outlet for the banks' funds, and to promote business recovery by opening up the mortgage market and reviving the construction industry." H.R. REP. No. 742, 74th Cong., 1st Sess. 14 (1935). The House recognized that, unlike other loans, real estate loans have suffered historically because "there was no organized market where they could be sold even at a reduced price." Id. at 15.

It should be noted the OCC that has used this House quotation regarding the legislative intent of the § 21 proviso out of context. The OCC citation is directed at a legislative discussion of whether banks should be allowed to make loans on real estate. See id. at 14-15.

95. See supra note 80.
96. See National Bank May Underwrite, supra note 80 at 77,543 (April 12, 1983). In this decision, the OCC held that a national bank could underwrite and deal in pass-through certificates, a predecessor of the CMO. The mortgage-backed pass-through certificates evidenced undivided interests in pools of project mortgage loans insured by the Federal Housing Association (FHA) and sold by the GNMA. Id. at 77,543. The pools were structured according to both FHA regulations and a pooling and servicing agreement. Id.
of the interest in the mortgages did not alter the basic characteristic of
the transaction: the bank's sale of instruments in its mortgage-related
portfolio.  

The OCC also found that Liberty Norstar's proposed CMO activities
would not violate either section 20 or section 32 of the Act.  In instances
where the underlying pool of mortgages would contain conventional mort-
gages from the bank's portfolio, Liberty Norstar agreed to abide by section
3(c)(5)(C) of the Investment Company Act of 1940.  That provision ex-
empts from the Glass-Steagall Act's definition of "investment company"
those entities not engaged in the business of issuing redeemable securities,
installment type face-amount, and periodic payment plan certificates; and
those entities that are primarily engaged in mortgages, leins on, and interests
in securities.  By qualifying for this exemption, the OCC reasoned, Lib-
erty Norstar would not be "primarily engaged" in securities underwriting
for purposes of section 32. Because the test for engaging in securities ac-
tivities is more stringent under section 32, the bank a priori could not be in
violation of section 20.  The bank's proposal also contained various safeguards to protect both it-
self and its investors. For example, Liberty Norstar agreed to file a register-
ation statement with the Securities and Exchange Commission (SEC)
pursuant to the Securities Act of 1933.  The loans placed in the pools were insured according to the exemption found in § 16, and were therefore found to be exempt.  The OCC also found the pass-through certificates to be exempt.  Each certificate represented an undivided interest in the pool of ex-
empted loans.  The pooling and servicing agreement obligated the servicer to remit all payments and collections above the amount of the service fee to the certificate holders.  The servicer was also obligated to pursue on behalf of the certificate holders any rights against the Department of Housing and Urban Development.  Thus, the OCC held that the pool was not the obligor of the underlying loans but was merely a pass-through vehicle. Therefore, because the pool was not legally transparent in all respects material to § 16, and because the pass-through certificates were not substantially different from the underlying loans, the certificates were found to be exempt from § 16 under the same provision which exempted the loans.  

97. Letter from Robert L. Clarke, Comptroller of the Currency, to Sen. Alfonse M. D'Amato (June 18, 1986) at 5.  The OCC clarified that they were only approving the bank's use of its own mortgages as collateral. "The activity in question amounts only to a transfer by the banks of its own mort-
gage assets and obligations."  Id. at 7 (emphasis added).

98. See supra notes 52-59 and accompanying text.
101. See supra notes 56-59 and accompanying text.
102. See supra notes 55, 57, and accompanying text.
prospectus be delivered to all prospective investors. The bank also agreed to have the quality of its CMOs rated by an independent agency. Bank-eligible CMOs are backed by the United States, either implicitly or explicitly. The government guarantee of GNMA, FNMA, and FHLMC makes bank-eligible CMOs virtually riskless. Nongovernment securities, including private CMOs, may be rated by rating agencies such as Moody’s or Standard and Poor’s so that investors will have a recognizable standard by which to judge each issuance. The bank agreed that its CMOs would have an AAA rating, the highest bond rating possible, to safeguard investors.

To further protect investors under the Liberty Norstar proposal, in case of nonpayment, the trustee would be required to seek payments from appropriate obligors on behalf of the bondholders pursuant to the Trust Indenture Act, thereby providing bondholders with the same rights, liabilities, and risks as if they were direct owners. The bank was also protected by underwriting its CMOs through a bank subsidiary whose assets would consist solely of the CMOs and underlying mortgages. In case of nonpayment, the indentured trustee bondholders would have recourse only against the bank subsidiary; the trustee would have no recourse against the bank. Therefore, no bank assets would be “at risk.”

B. Underwriting CMOs: Borrowing of Funds

The OCC also based its Liberty Norstar decision in part on a bank’s authority to borrow funds. Section 16 allows national banks to exercise “all such incidental powers as shall be necessary to carry on the business of bank-

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105. See supra notes 14-16.

106. For information on how the investment rating services rate CMOs and other mortgage-backed securities as investments, see Moody's Approach to Rating Mortgage-Backed Securities, 76 Moody's Bond Survey 4331 (1984).

107. 15 U.S.C. § 77aaa-77bbb. Under the Trust Indenture Act, debt securities may not be sold to the public unless they are issued pursuant to a trust indenture. This Act requires the trustee to notify all holders of any default within 90 days. Id. at § 77bbb(b). The trustee must have authority to recover judgments and to file proofs of claims in judicial proceedings upon default. Id. at § 77qqq(a).


The OCC concluded that where the CMOs are not an outright sale of the bank’s interest in real estate, they may be viewed as a borrowing of funds by the bank which uses the underlying securities as collateral. According to the OCC, this borrowing is permitted by the Glass-Steagall Act as an incidental power.112

The OCC’s no-action letter authorized Liberty Norstar to issue, underwrite, and deal in CMOs.113 At no point in either the no-action letter or the OCC’s response to Senator D’Amato did the OCC set forth any legal analysis demonstrating the authority for the bank to deal in CMOs.114

III. THE COMPTROLLER’S DECISION REGARDING LIBERTY NORSTAR BANK’S UNDERWRITING IS CORRECT

Despite the obvious importance of the issues addressed in the Liberty Norstar decision, the OCC produced a no-action letter that is completely devoid of legal analysis. Even in response to a demand for a legal justification from Senator D’Amato,115 the OCC still produced only a minimal, superficial legal analysis to support its decision.

Although it is not apparent from the OCC ruling, a careful review of the Glass-Steagall Act, as well as case law interpreting the Act, reveals sufficient statutory authority to support the OCC’s determination that banks may underwrite both bank-eligible and their own CMOs. Nevertheless, the same analysis will show that, contrary to the OCC’s conclusion, there is no authority for banks to deal in other than bank-eligible CMOs.

A. Underwriting a Bank’s Own CMOs

There are three rationales supporting a bank’s authority to underwrite its own CMOs. Two of those bases—the power of banks to sell interests in real estate, and to borrow funds—are addressed in the OCC opinion.116 A third

112. See Letter from Robert L. Clarke, Comptroller of the Currency, to Sen. Alfonse M. D’Amato (June 18, 1986) at 5-6; see also 12 U.S.C. § 24 (Seventh). (“[Banks] shall have power . . . [t]o exercise by its board of directors . . . all such incidental powers as shall be necessary to carry on the business of banking.”)
115. See supra notes 72 & 74 and accompanying text.
rationale not considered by the OCC, a bank’s authority to liquify its holdings under the incidental powers clause, also supports this conclusion.

1. Sale of an Interest in Real Estate

Sections 16 and 21 of the Glass-Steagall Act are to be read harmoniously.117 Section 16 specifically authorizes a bank to deal in, underwrite, and purchase for its own account obligations of the United States, including GNMAs, FNMs, and FHLMCs.118 Section 21 also authorizes banks to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate.119 As the OCC decision correctly noted, the legislative history of section 21 makes clear that the section was not meant to bar banks from selling mortgage securities on a nonrecourse basis.120 Therefore, if a security fits into the section 21 exception, it will not be barred by section 16.

An interest in a CMO is actually an interest in the mortgages that have been pooled to provide additional protection for the investor.121 The OCC has determined that national banks may purchase and hold investment company shares without limitation if the underlying portfolio, which consists wholly of bank-eligible obligations, is itself an eligible obligation.122 Under the OCC transparency theory, therefore, where a CMO is backed by bank-eligible mortgages, the CMO is also bank-eligible.123 Under section 21, banks are permitted to sell, “without recourse or agreement to repurchase, obligations evidencing loans on real estate.”124 Consequently, where a CMO is backed by mortgages made eligible under section 21, banks should be permitted to sell such securities without violating the provisions of the Glass-Steagall Act.125 Because under section 21 banks are permitted to sell their own mortgages,126 they should also be permitted to sell CMOs backed by their own mortgages.

The Comptroller’s Liberty Norstar position on underwriting is also consistent with long-standing OCC precedent. For close to a decade, the OCC has allowed banks to sell pass-through participations in a pool of the bank’s mortgages.127

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117. See supra notes 47-49 and accompanying text.
118. See supra note 45 and accompanying text.
119. See supra note 50 and accompanying text.
120. Section 21(a)(1) “does not permit banking institutions from selling mortgages without recourse.” Hearings Before the Subcomm. of the Senate Comm. on Banking and Currency, 74th Cong., 1st Sess. 113 (1935).
121. See K. Lore, supra note 14, at 3-18.
123. See supra notes 82-85 and accompanying text.
125. See infra notes 146-47 and accompanying text.
mortgages under the authority of section 21.\textsuperscript{127} An analysis of Liberty Norstar's proposal to sell CMOs is comparable in all material respects to those pass-throughs already approved by the Comptroller.

2. \textit{The Borrowing of Funds}

The OCC justifiably relied on bank authority to borrow funds under the "incidental powers" clause of the Banking Act of 1933\textsuperscript{128} in deciding Liberty Norstar. The Supreme Court granted banks the authority to borrow funds and to incur debt as early as 1875. In \textit{First National Bank v. National Exchange Bank},\textsuperscript{129} the Supreme Court defined the term "incidental powers" as those powers required to meet the legitimate demands of the authorized business of banks, as well as enabling the bank to conduct its affairs safely and prudently within the confines of its charter.\textsuperscript{130} The Court concluded that this definition necessarily implied "the right of a bank to incur liabilities in the regular course of its business" and to become the creditor of others.\textsuperscript{131}

The Court has consistently upheld the right of a bank to borrow money.\textsuperscript{132} Congress expanded this right in 1982 by removing the limitations previously placed on the amount a bank could borrow.\textsuperscript{133} Thus, there is authority to support the OCC's view that CMO's are the authorized borrowing of funds by a bank without limitation as to amount.

3. \textit{Liquidity as an Incidental Power}

There is yet another ground, although not addressed by the OCC in its decision, that supports a bank's authority to underwrite private CMOs. Banks are authorized to perform any activity "necessary to carry on the business of banking"\textsuperscript{134} through the incidental powers clause.\textsuperscript{135} In order to fall within the clause, the banking activity must be convenient or useful in connection with the bank's performance of one of its express powers.\textsuperscript{136} One such recognized incidental power is the power to maintain liquidity of as-

\textsuperscript{127} See \textit{supra} notes 90-97 and accompanying text.
\textsuperscript{128} Pub. L. No. 73-66, 48 Stat. 162 (1933).
\textsuperscript{129} 92 U.S. 122 (1875).
\textsuperscript{130} Id. at 127.
\textsuperscript{131} Id.
\textsuperscript{134} 12 U.S.C. § 24 (Seventh).
\textsuperscript{135} See \textit{supra} note 40 and accompanying text.
\textsuperscript{136} Arnold Tours, Inc. v. Camp, 472 F.2d 427, 432 (1st Cir. 1972).
sets. One means by which national banks may maintain liquidity is the "sale of mortgages and 'other evidences of debt' " acquired through loan or discount with a view toward reinvestment. Under this analysis, a bank may underwrite its own CMO's because these transactions are a source of liquidity permitted under the incidental powers provision. This avenue of liquidity is particularly important in view of the deregulation that is occurring in the banking industry.

The high interest rates of the 1970's played a large role in the deregulation of banks. As interest rates rose, investors left banks who were limited by law in the amount of interest they could pay to depositors, and invested their money in securities firms whose interest rates were not regulated. In response to the resulting loss of business experienced by banks, Congress deregulated the banking industry.

Due to deregulation, banks must now pay market-rate interest to their depositors in order to stay competitive. At the same time, the interest rates that banks are collecting from outstanding loans are the same rates that were negotiated at the time the loan was given. Consequently, banks are forced to pay competitive interest rates while still earning the prederegulation interest rates on long-term loans which are their traditional source of income. To make up for the disparity between the price they are forced to pay in interest on deposits and the amount of interest being collected on long-term loans, banks are turning to the securitization of their assets and the sale of those assets in the market.


141. Loring & Brundy, supra note 149, at 351.

142. See G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW, § 11.4, at 672-74 (1979) [hereinafter G. OSBORNE].

143. Id. Mortgage lending institutions' main source of income is their mortgage portfolios. Id.

144. See Solomon, supra note 149, at 2162.
The authority for banks to securitize their assets is found in the incidental powers clause of section 16.145 The Supreme Court has interpreted the incidental powers clause to permit the sale of mortgages "acquired by way of loan or discount with a view [toward] reinvestment . . . "146 Because banks may sell the underlying mortgages, under the transparency theory147 they should also be permitted to sell pass-throughs representing the underlying mortgages.

Similar authority is found in the incidental powers clause itself. In order for a power to be incidental, the activity in question must be convenient or useful in connection with a permissible activity under the Glass-Steagall Act.148 For example, banks are permitted to own and lease personal property if the leasing arrangements are the functional equivalent of long-term loans in which the bank retains a security interest in the property through legal ownership.149

This same analysis may be applied to underwriting CMOs. Securitization of a bank's own mortgages is needed to keep banks liquid and competitive in today's market.150 Therefore it is arguable that underwriting CMOs, whether eligible or ineligible, is a permissible activity under the Act because it is convenient and useful to the business of banking, and because banks need to remove these long-term assets from their balance sheets.

4. Deference as a Factor

Although not a substantial factor in reviewing the OCC's action, the deference that the judiciary normally affords agency decisions suggests that the Liberty Norstar no-action letter would be upheld if challenged in court. The Supreme Court has held that, in reviewing past OCC decisions, the position taken by the Comptroller should be given great deference.151 This judicial deference is conditioned upon close examination of the language, history, and purposes of the Act in view of the proposed activity.152 Generally, courts will defer to the agency charged with the enforcement of a statute

145. See supra notes 40-44.
147. See supra notes 87-90 and accompanying text.
149. M & M Leasing Corp., 563 F.2d at 1382.
150. See Solomon, supra note 139, at 2162. For a discussion of securitization, see Pavel, Securitization, 8 ECONOMIC PERSPECTIVES 16 (1984).
where the agency has adopted a reasonable construction of the regulatory statute.\textsuperscript{153} The courts' deference is based on the OCC's specialization in these issues.\textsuperscript{154} The OCC's judgment would be overturned only if there was no reasonable basis to sustain the opinion, or if the OCC exercised its judgment in a manner which clearly exceeded its statutory authority.\textsuperscript{155}

Thus, the OCC's decision to permit Liberty Norstar to underwrite its own CMOs is supported by the sale of an interest in real estate theory,\textsuperscript{156} the borrowing of funds theory,\textsuperscript{157} and the liquidity theory.\textsuperscript{158} Because each of these theories is a reasonable basis for the OCC decision, it is likely that the Liberty Norstar decision on underwriting and issuing, if challenged in court, would be upheld.

\textbf{B. The Comptroller's Decision Permitting Liberty Norstar Bank to Deal in its Own CMOs Is Incorrect}

In addition to authorizing Liberty Norstar to underwrite its own CMOs, the OCC also summarily granted the bank authority to deal in its own CMOs.\textsuperscript{159} Contrary to the OCC's Liberty Norstar decision, there is no authority in the Glass-Steagall Act that would permit banks to deal in their own CMOs.\textsuperscript{160} Additionally, although not addressed by the OCC in the Liberty Norstar decision, there is no authority in the Act which would permit banks to underwrite or deal in third-party CMOs.\textsuperscript{161}

The concept of dealing requires both the ability to purchase and the ability to sell.\textsuperscript{162} Thus, in order to deal in CMOs, the bank must be able to sell and purchase CMOs in the secondary mortgage market. While there is authority in the Glass-Steagall Act that allows banks to sell CMOs, the Act contains no authority that would permit banks to purchase CMOs.\textsuperscript{163}

\begin{footnotes}
\item[154.] Board of Governors of the Fed. Reserve Sys. v. Agnew, 329 U.S. 441, 450 (1947) (Rutledge, J., concurring). "Their specialized experience gives them an advantage judges cannot possibly have, not only in dealing with the problems raised for their discretion by the system’s working, but also in ascertaining the meaning Congress had in mind in prescribing the standards by which they should administer it." Id.
\item[155.] Id.
\item[156.] See supra notes 117-27 and accompanying text.
\item[157.] See supra notes 128-33 and accompanying text.
\item[158.] See supra notes 134-38 and accompanying text.
\item[159.] Proposal Letter, supra note 62, at 76,614.
\item[160.] See supra notes 43-46 and accompanying text.
\item[161.] See 12 U.S.C. § 24 (Seventh).
\item[163.] See supra notes 43-46 and accompanying text.
\end{footnotes}
None of the rationales supporting a bank's authority to underwrite CMOs applies to the question of purchasing. In contrast to the selling of CMOs, the purchasing of CMOs cannot be characterized either as a sale of the bank's interest in real estate or as a borrowing of funds. Moreover, a bank's purchasing of CMOs cannot be characterized as a method of liquifying the bank's long-term assets. Such a purchase does not liquify the bank's assets. Indeed, the bank would be trading its liquid assets for a long-term asset. Therefore, purchasing CMOs is prohibited by section 16 because there is no exception found in the Act which would take the purchase of CMOs out of section 16's general prohibition against purchasing securities for their own account. If banks are not allowed to purchase CMOs, they lack the ability to both purchase and sell CMOs and therefore are precluded from dealing in CMOs.

Banks are precluded from underwriting, or dealing in third-party CMOs under the same theory that prohibits banks from dealing in their own CMOs. In order to underwrite or deal in third-party CMOs, the bank must first purchase the third-party CMOs in the secondary mortgage market. Because banks are specifically prohibited from purchasing CMOs for their own account, they are prevented from underwriting or dealing in third-party CMOs.

IV. PROPOSED LEGISLATION

Based on an analysis of the Glass-Steagall Act and case law interpreting the Act, it is clear that although banks may underwrite both bank-eligible and their own CMOs, there is no authority for them to underwrite third-party CMOs or to deal in other than bank-eligible CMOs. Legislation is needed to expand bank powers in this area.

The question whether banks can issue, underwrite, and deal in CMOs has received considerable attention in recent legislation, proposed legislation, and congressional committee reports. This legislative material sheds considerable light on the public policy issues underlying national bank participa-

164. Id.
165. Banks do possess authority to buy mortgages in the secondary mortgage market. See Secondary Mortgage Market Enhancement Act of 1984, 12 U.S.C. § 24 (Seventh). Therefore, a bank could conceivably buy third-party mortgages for the bank's portfolio. These mortgages could then be packaged and sold as the bank's own CMOs. Thus, a bank could, through this circuitous method, avoid the prohibition against dealing in third-party CMOs. See infra note 169 and accompanying text.
166. See supra notes 43-46 and accompanying text.
167. See supra notes 25-29 and accompanying text.
168. See infra notes 171, 175, & 187.
tion in the CMO markets. The congressional committees that have reviewed these issues appear to agree that banks should have expanded authority in this area.

Congress has repeatedly come close to passing legislation that would grant further authority for banks to issue, underwrite, and deal in CMOs. In 1984, the Senate Committee on Banking, Housing, and Urban Affairs (the Senate Committee) submitted the Financial Services Competitive Equity Act of 1984 (the 1984 Act) to the full Senate. The 1984 Act was "designed to clarify and revise the statutory framework under which financial institutions operate and compete," and gave bank holding companies and their subsidiaries new power to underwrite and deal in mortgage-backed securities. In proposing the 1984 Act, the Senate Committee expressed concern for the liquidity of national banks in today's market.

The House Committee on Banking, Finance, and Urban Affairs (the House Committee) noted that it had considered carefully the implications of permitting depository institution holding companies to underwrite MBSs. The House Committee concluded that permitting banks to underwrite MBSs was consistent with safety and soundness, and necessary because, as the traditional avenues of income dry-up for depository institutions, banks would need to take advantage of available opportunities in related markets where they have expertise. Otherwise, banks could become supervisory

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170. See infra notes 173, 176, 184, 185 & 189 and accompanying text.
171. S. REP. NO. 560, supra note 28. The bill passed in the Senate by a vote of 89-5, but was not brought to a vote in the House, due primarily to hostility aimed at closing the nonbank bank loopholes. CONG. Q. ALMANAC 271-76 (1984).
173. The Committee explained that the proposed legislation would "permit a DISA to underwrite or deal in what are commonly referred to as mortgage related obligations." Id. at 17. The proposed legislation defined mortgage related payment bonds as "obligations, with or without recourse, that provide for the payment of principal on the basis of payments or reasonable projections of payments on notes secured by real estate and that are rated in one of the four highest rating categories by a nationally recognized rating organization." Id. at 16-17.
174. See infra note 176.
176. The Committee noted that:

Encouraging the provision of capital to finance the housing needs of this country has always been a matter of significant Congressional concern and interest. Recent estimates by the Federal National Mortgage Association "FNMA" suggest that $1.6 trillion or more will be needed to finance home mortgages between now and 1990. Much of this amount (approximately one-half according to FNMA) will be financed through the origination of mortgages and their resale into the secondary market. The purchase of a single mortgage by an investor may be unattractive, however, because of the risk of repayment prior to the stated maturity date. The pooling of
cases on a nationwide basis.\textsuperscript{177}

The fact that mortgage-related securities, including CMOs, are devices that could help banks cope with the problem of restructuring the earning of money on loans at rates below which they pay for deposits, a problem created by the deregulation of interest rates was also considered by the House Committee.\textsuperscript{178} The Committee members noted that the tremendous volatility of interest rates in recent years had a profound effect on depository institutions participating in housing finance.\textsuperscript{179}

Because of volatile interest rates, it is no longer practical for banks to make and retain long-term, fixed-rate mortgages.\textsuperscript{180} In response, more and more banking institutions have sought to make and service mortgages, and to remove the interest rate risk from the bank by securitizing the loan, therefore placing the risk on the secondary market or on investors who are in a position to earn an elusive interest rate spread.\textsuperscript{181}

The OCC cited this concern as a factor in the \textit{Liberty Norstar} decision.\textsuperscript{182} The Reagan administration is in favor of such underwriting, in part for this reason.\textsuperscript{183} Finally, even the Federal Reserve Board has joined the Commit-
This issue was again addressed in the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA"). The SMMEA was drafted in response to projections that demands for mortgage credit would exceed the mortgage liquidity which the federal agencies would be able to provide. The Senate Committee feared that the scarcity of liquid mortgage funds would raise the cost of mortgages in addition to making them more cumbersome to obtain. As introduced, the SMMEA would have explicitly granted national banks authority to underwrite and deal in MBSs. Both the House and Senate Committees recognized the benefits that expansion of bank powers in the MBS market would create. Nevertheless, the section was withdrawn in deference to the Reagan administration and the SEC, both of which preferred that the issuance of MBS be considered with other forms of securities underwriting as proposed in the Financial Institution Deregulation Act.

Congress should act to amend section 16 to include both MBSs and CMOs. This would extend to banks a new, safe method of liquifying long-

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184. This view is confirmed by the statement of Chairman Volcker regarding the underwriting of mortgage backed securities proposed in H.R. Rep. No. 889, supra note 104:

The mortgage market is being transformed by innovations in communications technology and in marketing techniques. Banking organizations are major mortgage lenders and are familiar with the credit analysis and have other expertise necessary to establish mortgage pools and evaluate the underlying risks of the constituent elements in the pool. They can already underwrite mortgage bonds guaranteed by the government or sold by government-related agencies . . . . The Board believes that these activities (e.g., underwriting private mortgage-backed securities) involve a manageable degree of risk for banking organizations and there is potential for substantial gain for customers in terms of a variety of services and lower costs.

Id. at 46.


188. Id.

189. "The Committee, while taking this action, recognizes the increase in volume and market liquidity that would result by having bank participation." Id. at 2817.

term loans. This added liquidity would enable banks to continue making real estate loans available for those who need them. Not only is the proposed legislation consistent with important public policy interests, but, under current law, it will not add excessively to those activities that are already permitted in the banking industry.

Given the current language of the Glass-Steagall Act, banks may already underwrite CMOs backed by bank-eligible mortgages—GNMA, FNMA, and FHLMC. A national bank may also underwrite CMOs backed by the bank’s own mortgages under the authority of section 21. Banks may buy and sell private CMOs as agent for their customers. Banks may also privately place CMOs as agent for an issuer. Consequently, banks and their affiliates are more than “generally equipped” to offer CMO services.

Proposed legislation would add to these activities the authority for banks to deal in the secondary market. Presumably this would provide banks with authority to repurchase CMOs backed by their own mortgages, as well as purchase third-party mortgages in the secondary market to back the bank’s CMOs. This authority does not seem excessive in light of the expansive authority already possessed by banks.

In addition, banks currently have the authority to participate in the secondary mortgage market pursuant to SMMEA. The SMMEA amended section 16 to remove the limitation and restrictions regarding a national bank’s purchase of mortgage-related securities for its own account. Under the SMMEA, banks are permitted to invest in privately insured CMOs originated by other financial institutions.

A comparison of the investment activities permitted by the SMMEA with the activities involved in underwriting and dealing in third-party CMOs suggests that the latter would be less risky and would better accomplish the

192. See supra notes 78-80 and accompanying text.
195. See supra notes 171-81 and accompanying text
196. In its comments on the proposed legislation, the Senate Committee noted that, “[t]he provision of the bill authorizing DISA’s to underwrite or purchase and sell mortgage backed securities merely clarifies that these affiliates of depository institutions can continue to occupy an integral role in this evolving method of real estate financing.” S. REP. NO. 560, supra note 28, at 17.
198. Id.
199. Id.
public policy objectives underlying the SMMEA\textsuperscript{200} and legislation proposed by both the House and Senate Committees.\textsuperscript{201} For example, a bank's investment in third-party CMOs requires the bank to invest its liquid assets in someone else's CMO.\textsuperscript{202} This is contrary to congressional goals of increasing liquidity in the mortgage market.\textsuperscript{203} In addition to tying up the bank's liquid assets, the bank would only be able to earn interest income on its investment.\textsuperscript{204} If allowed to underwrite and deal in CMOs, the bank would be able to purchase and sell CMOs in response to fluctuations of the market.\textsuperscript{205} Additionally, by underwriting and dealing in CMOs, the bank would be using its liquid assets to create more liquid assets.\textsuperscript{206} When market conditions prevent the bank from selling its investment for a profit, the bank would still have the option to hold onto its CMO interest until the market improves.\textsuperscript{207} By generating more funds and providing more liquid capital for the bank to redirect to its customers, underwriting and dealing in CMOs by banks does seem less risky and more beneficial than the investment activities authorized by the SMMEA.\textsuperscript{208}

Thus, by passing proposed legislation, Congress would be providing liquidity to banks while providing more money to families to purchase homes.\textsuperscript{209} Both of these objectives could be accomplished by only a slight expansion of bank authority.\textsuperscript{210}

In addition, the proliferation of the secondary market in CMOs would provide its own public benefits. It would enhance competition and help to equalize the access to credit which ordinarily is geographically distributed.\textsuperscript{211} Further, the secondary market in CMOs would liquify an otherwise nonliquid market\textsuperscript{212} while providing investors with an alternative investment choice. More importantly, it would ensure the availability of credit for consumers and perhaps also lower the cost of that credit.\textsuperscript{213}

\textsuperscript{200} See S. REP. NO. 293, supra note 187, at 2.
\textsuperscript{201} See S. REP. NO. 560, supra note 28, at 17; see also H.R. REP. NO. 889, supra note 109, at 46.
\textsuperscript{202} See supra text accompanying note 28.
\textsuperscript{203} S. REP. NO. 293, supra note 187, at 2. Instead of providing the bank with a ready source of cash, purchase of CMOs reduces the bank's liquidity.
\textsuperscript{204} See supra notes 141-44 and accompanying text.
\textsuperscript{205} See K. LORE, supra note 14, at 1-42.
\textsuperscript{206} See id.
\textsuperscript{207} See K. LORE, supra note 21, at 3-20 to 3-21.
\textsuperscript{208} See supra notes 200-03 and accompanying text.
\textsuperscript{209} See supra notes 134-38 and accompanying text.
\textsuperscript{210} See supra notes 185-97 and accompanying text.
\textsuperscript{211} P. GOLDSTEIN, REAL ESTATE TRANSACTIONS 323 (2d ed. 1985).
\textsuperscript{212} Id. at 319.
\textsuperscript{213} Studies indicate that an efficient market may lower the cost of credit as much as one half of one percent. See Lance, Balancing Private and Public Initiatives in the Mortgage-
V. CONCLUSION

An analysis of the Liberty Norstar decision, in light of the Glass-Steagall Act, demonstrates that the decision, albeit controversial, is correct to the extent that it allows national banks to underwrite and deal in bank-eligible CMOs and to underwrite the bank's own CMOs. A bank's authority to underwrite and deal in bank-eligible CMOs is established explicitly in section 16 of the Act. Authority for banks to underwrite their own CMOs is based on the section 21 clause, that allows banks to sell obligations evidencing loans on real estate and on the OCC's legal transparency theory. The same analysis, however, shows that the Liberty Norstar decision was incorrect in permitting banks to deal in their own CMOs. Additionally, banks are prohibited from underwriting or dealing in third-party CMOs. Because there is no exception to the Act's general prohibition against banks underwriting, dealing in, or purchasing securities for its own account, banks are forbidden to deal in their own CMOs or to underwrite or deal in third-party CMOs.

A careful study of the CMO market shows that an extension of the bank's power to participate in the CMO market is both plausible and necessary. It is plausible because the extra authority would not add significantly to the power already possessed by banks under the Act. The extension is necessary to provide liquidity to the bank's mortgage portfolio and to raise fee income to help fund future loans.

Legislation is needed to authorize banks to expand in the CMO market. Banks have reached the outer limits of permissible CMO activities under the Glass-Steagall Act. If banks are allowed to expand into the CMO market, legislation is also needed to guarantee that the safeguards found in the Liberty Norstar proposal will be adopted in all CMO proposals. There is also a public policy reason why banks should be able to expand their powers in the lucrative CMO market: liquidation of the banks' long-term assets provides additional funds for the home-buying market at a lower cost.

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Backed Security Market, 18 REAL PROP., PROB. & TR. J. 426, 427 (Summer 1983); see also S. REP. NO. 560, supra note 28, at 97 (additional views of Sen. Proxmire: "The ultimate beneficiary will be the American homebuyer whose borrowing costs will be reduced."); S. REP. NO. 293, supra note 187, at 2. Solomon, supra note 149, at 2160-64.