

COVERAGE OF SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT

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Introduction:

This memorandum will describe the provisions of sections 23A and 23B of the Federal Reserve Act (“Act”), which regulate loans, purchases of assets, and certain other transactions between an insured depository institution and its affiliates.¹

A. Section 23A

Section 23A of the Act, originally enacted as part of the Banking Act of 1933, is designed to prevent the misuse of a bank’s resources through “non-arm’s-length” transactions with its affiliates and to limit the ability of a bank to transfer its federal subsidy to its affiliates.² Section 23A prohibits a bank from engaging in so-called “covered transactions” with an affiliate unless the bank limits the aggregate amount of such transactions to that particular affiliate to 10 percent of the bank’s capital stock and surplus. Section 23A limits the aggregate amount of all covered transactions between

¹ 12 U.S.C. 371c & 371c-1; 12 CFR part 223. Sections 608 and 609 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) amended sections 23A and 23B. These amendments took effect on July 21, 2012. Staff currently is revising Regulation W to reflect these changes.

² 12 U.S.C. 371c. As originally enacted, the Banking Act of 1933 covered only member banks. In 1966, Congress amended section 18(j) of the Federal Deposit Insurance Act, 12 U.S.C. 1828(j), to extend the coverage of section 23A to include insured nonmember banks. As a result of FIRREA, section 23A also applies to savings associations as if they were member banks. 12 U.S.C. 1468. See subsection D for a discussion of savings associations and the application of sections 23A and 23B.

a bank and all its affiliates to 20 percent of the bank's capital stock and surplus.

In 1999, the Gramm-Leach-Bliley Act ("GLB Act") amended section 23A to extend the statute's coverage to covered transactions between banks and their financial subsidiaries by including financial subsidiaries in the definition of affiliate.³ In addition, the GLB Act provides that the purchase of, or investment in, securities issued by a financial subsidiary of a bank by an affiliate of the bank counts towards the bank's quantitative limits.

In October 2002, the Board formally adopted Regulation W to implement sections 23A and 23B of the Federal Reserve Act.⁴ Regulation W provides a comprehensive reference tool for complying with the statute. The regulation restates the statutory provisions, includes many of the Board's interpretations of the statute, and addresses issues that arose as a result of the GLB Act. Regulation W also provides general guidance on the timing and valuation of covered transactions.

1. Covered Transaction

The following transactions are covered transactions for purposes of section 23A:

- (1) a loan or extension of credit by a bank to an affiliate; including assets subject to an agreement to repurchase;⁵

³ Pub. L. No. 106-102 § 121, 113 Stat. 1338, 1378 (codified at 12 U.S.C. 371c(e)).

⁴ 67 Fed. Reg. 76,560 (Dec. 12, 2002) (codified at 12 CFR part 223).

⁵ An extension of credit includes the sale of fed funds to an affiliate and the purchase of an obligation of an affiliate, including commercial paper or other debt securities. An extension of credit includes any similar transaction as a result of which an affiliate becomes obligated to pay money or its equivalent to the bank. 12 CFR 223.3(o).

- (2) a purchase by a bank of, or an investment by a bank in, securities issued by an affiliate;
- (3) a purchase by a bank of assets from an affiliate;⁶
- (4) the acceptance by a bank of securities or other debt obligations issued by an affiliate as collateral for a loan or extension of credit by the bank to any person or company;
- (5) the issuance by a bank of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate;
- (6) the credit exposure resulting from a securities lending and borrowing transaction with an affiliate; or
- (7) the credit exposure resulting from derivative transactions with an affiliate.

If the transaction between the bank and an affiliate does not fall into one of these categories, the transaction is not a covered transaction for purposes of section 23A and is not subject to its limitations. For example, dividends or fees paid by the bank to a parent holding company generally are not covered transactions under section 23A.

2. Transactions with Third Parties Subject to Section 23A

Under section 23A, any transaction by a bank with a third party is deemed a transaction with an affiliate to the extent that the proceeds of that transaction are used for the benefit of, or transferred to, the affiliate. This provision broadens the coverage of section 23A.⁷ For example, if an individual controls both a bank and a car dealership and a customer of the

⁶ A purchase of assets includes a novation or any transaction, including the donation of a subsidiary or an asset, resulting in the assumption or liabilities by the insured depository institution.

⁷ 12 U.S.C. 371c(a)(2).

car dealership obtains a loan from the bank for the purpose of purchasing a car from the dealership, the transaction is deemed to be a covered transaction subject to section 23A because the proceeds of the loan are transferred to, and directly benefit, the affiliate.⁸ Regulation W clarifies that a customer's use of a bank-issued general purpose credit card to purchase goods and services from an affiliate of the bank is an extension of credit to the affiliate, but provides an exemption for institutions where less than 25 percent of the total value of the purchases with the card are purchases from affiliates of the bank or where all the affiliates are permissible for a financial holding company.⁹ Regulation W also exempts certain agency and riskless principal transactions, where the proceeds are transferred to an affiliate.¹⁰

3. Specific Additional Prohibitions

In addition to limiting the amount of covered transactions to 10 and 20 percent of an institution's capital stock and surplus, section 23A requires that banks conduct transactions with their affiliates on terms that are consistent with safe and sound banking practices.

Section 23A also prohibits certain affiliate transactions altogether. Most importantly, a bank may not purchase a low-quality asset (generally a classified or past-due asset) from an affiliate or accept a low-quality asset as collateral for a loan to any affiliate. A bank may not accept the securities issued by an affiliate for a loan to any affiliate.

⁸ This provision contrasts with Regulation O's tangible economic benefit rule, which provides that if the proceeds of the loan are used in a bona fide transaction to acquire goods, property, or services from an insider and the transaction is conducted on an arm's length basis, then the loan is not subject to Regulation O. 12 CFR 215.3(f).

⁹ 12 CFR 223.16(c)(4).

¹⁰ 12 CFR 223.16.

4. Definition of Affiliate

In general, section 23A defines companies that control or are under common control with the bank as “affiliates” of the bank.¹¹ For example, the term “affiliate” includes bank, financial, and savings and loan holding companies and their subsidiaries. Banks, savings associations, and nonbanking companies that are under common individual control with the bank also are affiliates for purposes of section 23A.¹² In addition, the GLB Act expanded the definition of affiliate to include financial subsidiaries of banks. Regulation W defines “financial subsidiary” to mean any subsidiary of a member bank that

- (1) engages, directly or indirectly, in any activity that national banks are not permitted to engage in directly or that is conducted under terms and conditions that differ from those that govern the conduct of such activity by national banks; and
- (2) is not a subsidiary that a national bank is specifically authorized to own or control by the express terms of a Federal statute (other than 12 U.S.C. 24a), and not by implication or interpretation.¹³

¹¹ 12 U.S.C. 371c(b)(1)(A).

¹² For example, banks that are part of a chain banking organization are “affiliates” under section 23A, and thus are subject to its restrictions. 12 U.S.C. 371c(b)(1)(C).

¹³ 12 CFR 223.3(p) & 223.32. An Edge Corporation is an example of a subsidiary that a national bank is specifically authorized to own by a federal statute.

Regulation W exempted many financial subsidiaries covered by the GLB Act, such as certain insurance agencies, grandfathered subsidiaries of state banks, and subsidiaries of state banks that engage in activities permitted for the bank directly under federal and state law.¹⁴

The GLB Act also created a rebuttable presumption that a company or shareholder controls a company if the company or shareholder directly or indirectly owns or controls 15 percent or more of the equity capital of the other company pursuant section 4(k)(4)(H) or (I) of the Bank Holding Company Act.¹⁵ These companies, which generally are referred to as portfolio companies, are affiliates under the statute.

Certain companies are deemed not to be affiliates for purposes of section 23A. Most importantly, nonbank subsidiaries of banks that are not financial subsidiaries are not affiliates for purposes of section 23A, unless the Board makes a determination to treat such subsidiaries as affiliates.¹⁶

5. Collateral Requirements

Section 23A establishes collateral requirements for certain transactions between a bank and an affiliate. Under the statute, each loan or extension of credit by a bank to an affiliate, each guarantee, acceptance, or letter of credit issued by a bank on behalf of an affiliate or the credit

¹⁴ 12 CFR 223.2(p).

¹⁵ 12 U.S.C. 371c(b)(11).

¹⁶ 12 U.S.C. 371c(b)(2)(A). The Board may make such a determination if it finds that transactions between the bank and the subsidiary may be affected by the affiliate's relationship to the detriment of the bank.

exposure resulting from securities lending or borrowing transactions, or derivative transaction must be secured at all times by collateral having a certain market value.¹⁷

Banks may accept cash, securities, receivables, leases, or other real or personal property as collateral for covered transactions. Section 23A and Regulation W prohibit a bank from accepting low-quality assets as collateral for a covered transaction, as well as intangible assets, guarantees, letters of credit, and equity securities of the lending bank.¹⁸ In addition, securities issued by an affiliate of the lending bank may not be used as collateral for a loan to that affiliate or any other affiliate.

If the loan is secured by obligations of the United States or its agencies, notes or drafts that are eligible for rediscount by a Federal Reserve Bank, or a segregated earmarked deposit account, the loan must be collateralized at 100 percent of the loan amount.¹⁹ Loans secured by the obligations of a state or political subdivision of a state, debt instruments (including receivables), stock, leases, or other real or personal property must be collateralized at between 110 and 130 percent of the loan amount.²⁰

6. Exemptions from Section 23A

Section 23A has a number of exemptions for certain transactions between banks and their affiliates. The most important exemption is for transactions that are between banks where the same company owns

¹⁷ Section 23A does not require a bank to secure a purchase of assets from an affiliate.

¹⁸ 12 CFR 223.14(c).

¹⁹ A representative list of acceptable government obligations is found in Regulation A, 12 CFR 201.108.

²⁰ The bank must perfect the security interest in the collateral. 12 CFR 223.14(d).

80 percent of each bank's shares.²¹ The "sister bank" exemption allows banks controlled by the same company to improve their efficiency through intercorporate transfers.²² Section 23A also exempts from its provisions a bank making deposits in an affiliated bank or affiliated foreign bank in the ordinary course of correspondent business.

Section 23A also exempts transactions where the bank gives immediate credit to an affiliate for uncollected items received in the ordinary course of business. In addition, section 23A exempts transactions that are fully secured by certain obligations of the United States government or its agencies or an earmarked deposit account. There also is an exemption for a bank's purchase of assets from an affiliate where the assets have a readily identifiable market price and the asset is purchased at that price. The Board expanded this exemption in Regulation W to include purchases of securities that have a ready market and a price that is routinely quoted on an unaffiliated electronic service.²³

In Regulation W, the Board expanded the types of transactions that are exempt from the quantitative and collateral requirements of section 23A to include the purchase of certain municipal securities, asset purchases by newly formed banks and intraday extensions of credit where the bank establishes and maintains policies and procedures to manage the intraday

²¹ "Sister bank" transactions are still subject to the prohibition against the purchase of low-quality assets and to the requirement that covered transactions be conducted on terms and conditions that are consistent with safe and sound banking practices.

²² "Company" in this context, is not limited to a bank holding company. Thus, two credit card banks that are 80 percent owned by a retail institution may take advantage of the sister bank exemption.

²³ 12 CFR 223.42(f).

credit risk.²⁴ The Board can exempt transactions or relationships by regulation,²⁵ so long as the FDIC does not object. After enactment of the Dodd-Frank Act, the Board, OCC and the FDIC can grant an exemption by order for the institutions for which they are the primary supervisor with the nonobjection of the FDIC and the concurrence of the Board.²⁶

7. Derivative Transactions & Securities Borrowing and Lending Transactions

The Dodd-Frank Act provides that a transaction with an affiliate that involves the borrowing or lending of securities is a covered transaction, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate. The statute also provides that a derivative transaction, as defined in paragraph (3) of section 5200(b) of the Revised Statutes of the United States (12 U.S.C. 84(b)), with an affiliate is a covered transaction, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.²⁷

This credit exposure must be secured at all times pursuant to the collateral requirements of Regulation W.²⁸ These provisions of the Dodd-Frank Act currently are in effect, and all insured depository institutions should be treating these credit exposures as covered transactions, using the same methodology to measure credit exposure that the institution uses with

²⁴ 12 CFR 223.42.

²⁵ The Board's 23A exemption determinations can be found on the Board's public website, https://www.federalreserve.gov/supervisionreg/legalinterpretations/federalreserveact_archive.htm.

²⁶ 12 U.S.C. 371c(f).

²⁷ 12 U.S.C. 371c(b)(7)(F) and (G).

²⁸ 12 U.S.C. 371c(c)(1); 12 CFR 223.14.

similarly situated third parties.²⁹ The transactions also are subject to section 23B.³⁰ Staff will provide additional guidance on the valuation of these transactions in the revised Regulation W.

B. Section 23B of the Federal Reserve Act

Section 23B provides that most transactions between a bank and its affiliates must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated companies.³¹ In the alternative, in an absence of comparable transactions, the transactions must be conducted on terms and under circumstances, including credit standards that in good faith would be offered to or applied to nonaffiliated companies. A bank also generally is prohibited from purchasing as a fiduciary securities or assets from an affiliate except under certain specified circumstances.

Finally, a bank and its affiliate may not advertise or enter into an agreement suggesting that the bank is in any way responsible for the obligations of the affiliate. Regulation W provides that a guarantee, acceptance, letter of credit, or cross-affiliate netting arrangement is permissible under section 23B if it meets the quantitative and collateral

²⁹ For example, if a bank includes a calculation for potential future exposure (“PFE”) when calculating credit exposure with its nonaffiliates, it must include a PFE calculation when determining its credit exposure with an affiliate.

³⁰ Regulation W provides that credit derivatives between a bank and a nonaffiliate in which the bank provides credit protection to the nonaffiliate with respect to an obligation of an affiliate of the bank is a guarantee under the regulation. 12 CFR 223.33(c).

³¹ The Competitive Equality Banking Act of 1987 added section 23B to the Act. Pub. L. No. 100-86, § 102 (1987) (codified at 12 U.S.C. 371c-1).

requirements of section 23A.³² As with section 23A, the Board has the authority to prescribe regulations to administer and carry out the Act. The Dodd-Frank Act provides the Board with the authority to exempt individual transactions from the requirements of section 23B with the nonobjection of the FDIC.

Section 23B applies to any covered transaction with an affiliate, as that term is defined in section 23A, but excludes banks from the term “affiliate.” Thus, transactions between “sister banks” and banks that are part of a chain banking organization are exempt from section 23B.³³ In addition, section 23B applies to a number of transactions not covered by section 23A. Section 23B applies to a bank’s sale of securities or other assets to an affiliate, including assets subject to an agreement of repurchase; the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise; any transactions in which an affiliate acts as an agent or a broker or receives a fee for its services; and any transaction or series of transactions with a third party, if an affiliate has a financial interest in the third party or is a participant in such transaction or series of transactions.

C. U.S. Branches and Agencies of Foreign Banks

Regulation W provides that a transaction between a U.S. branch or agency of a foreign bank and certain affiliates is subject to sections 23A and 23B.³⁴ The affiliates that are covered by the regulation are affiliates engaged in the United States in insurance underwriting, securities

³² 12 CFR 223.54.

³³ Although section 23B does not apply technically to transactions between affiliated banks, section 23A requires all transactions to be conducted on terms consistent with safe and sound banking practices. Staff has taken the position that safety and soundness requires market terms.

³⁴ 12 CFR 223.61.

underwriting and dealing, merchant banking, and insurance company investment activities.

D. Savings Associations

The Homeowners' Loan Act ("HOLA") subjects savings associations to sections 23A and 23B as if they were member banks.³⁵ In addition to sections 23A and 23B, HOLA also imposes several additional restrictions on transactions between savings associations and affiliates that do not apply to banks. These restrictions are as follows:

- (1) a savings association may not make a loan or extension of credit to any affiliate unless the affiliate is engaged only in activities that the Board, by regulations, determined to be permissible for bank holding companies under section 4(c) of the BHC Act,³⁶ and
- (2) a savings association may not purchase or invest in securities issued by any affiliate other than respect to shares of a subsidiary.³⁷

FIRREA authorized the Director of the Office of Thrift Supervision ("OTS") to impose additional restrictions on transactions between any savings associations and any affiliate as the Director deemed necessary to

³⁵ Sections 301 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") Pub. L. 101-73, 103 Stat 183, 342 (1989) amended HOLA and imposed the restrictions of sections 23A and 23B on savings associations. Representatives of savings associations often will refer to "TWA rules" (Transactions With Affiliates) when discussing sections 23A and 23B. Prior to FIRREA, savings associations were subject to some 23A provisions as well as a variety of other affiliate transactions rules. For a complete history, see Julie L. Williams, Savings Associations: Mergers, Acquisitions and Conversions § 13 (2011).

³⁶ 12 U.S.C. 1468(a)(1)(A) and 1467a(c)(2)(F)(ii).

³⁷ 12 U.S.C. 1468(a)(1)(B).

protect the safety and soundness of the institution.³⁸ In 2003, the OTS amended their regulations specifically to incorporate Regulation W as part of their regulations, with certain modifications.³⁹ The OTS regulation contained a chart with the regulatory differences between Regulation W and the rules savings associations must follow. One of the most important differences noted in the chart is the treatment of a company that Regulation W defines as a financial subsidiary. As noted above, financial subsidiaries generally are treated as affiliates of the bank.⁴⁰ When the Board adopted Regulation W, it determined that because of the ambiguities of the GLB Act and the additional restrictions that HOLA imposed on savings associations, the Board chose not to address the status of subsidiaries of savings associations as financial subsidiaries.⁴¹

As noted above, HOLA also imposed two additional section 23A-like restrictions on savings associations. OTS took the position that these additional restrictions are HOLA restrictions and NOT section 23A restrictions on savings associations, which allowed OTS to impose its own interpretation of the restrictions. The first restriction states that a savings association may extend credit to an affiliate only if the affiliate engages

³⁸ The Dodd-Frank Act eliminated OTS and transferred the supervision of savings associations to the OCC. On September 13, 2011, the Board issued a final interim rule that codified the OTS rules relating to section 23A as part of Regulation W. 76 Fed. Reg. 56,531 (Sept. 13, 2011) (codified at 12 CFR 223.72).

³⁹ 12 CFR 563.41 (2011).

⁴⁰ See n.14 and accompanying text.

⁴¹ 67 Fed. Reg. 76,560, 76,565 (Dec. 12, 2002). For example, HOLA requires savings associations to deduct from capital all investments in and extensions of credit to any subsidiary engaged in activities that are not permissible for national banks. 12 U.S.C. 1464(t)(5).

solely in the section 4 activities.⁴² The OTS regulation interpreted this provision not to prohibit transactions where the section 23A Attribution Rule on loans to a third party would generally apply. Thus, a loan or extension of credit to a third party is not prohibited merely because proceeds of the transaction are used for the benefit of, or transferred to, an affiliate that engages in a non-section 4 activity. Instead, the loan is permissible, but must meet the quantitative and collateral restrictions of section 23A.⁴³ For example, if Company A makes a loan to a customer so the customer can buy a tractor from Affiliate A, the loan is subject to section 23A and Regulation W, but is not prohibited by HOLA, even though the sale of tractors is not an activity permissible for a bank holding company under section 4(c).

The other major exception imposed by HOLA is that a savings association may not purchase or invest in securities issued by any affiliate other than with respect to the shares of a subsidiary. Thus, for example, a savings association cannot own 15 percent of a company if an affiliate owns more than 25 percent of the same company.

Certain exemptions under Regulation W may not be available to certain saving associations. For example, the exemption for general purpose credit cards that is available to all banks in a bank holding company is not available to a savings association if the savings association has affiliates that are impermissible for a financial holding company.⁴⁴ Thus, a savings association that has a department store or other retail affiliate cannot rely on

⁴² 12 CFR 223.72(c)(1).

⁴³ Id.

⁴⁴ 12 CFR 223.16(c)(4)(i). Special purpose credit cards issued by any insured depository institution that are used at affiliates always are subject to section 23A.

the exemption for general purpose credit cards and must consider general purpose credit card transactions by customers with the affiliate retailer as covered transactions under section 23A. Similarly, any exemption that requires a bank and its affiliates to be well capitalized is available to a savings association only if the holding company has and maintains at least the capital levels required for a bank holding company to be well capitalized.⁴⁵

⁴⁵ 12 CFR 223.3(kk) and 223.41(d)(7). Prior to the passage of the Dodd-Frank Act, savings and loan holding companies were not required to meet the same capital standards as bank holding companies.