

April 25, 2001

TO: Board of Governors

SUBJECT: Regulations

implementing sections 23A and

FROM: Staff¹

23B of the Federal Reserve Act.

ACTION REQUESTED: Approval to (1) request comment on a proposed Regulation W that would comprehensively implement sections 23A and 23B of the Federal Reserve Act; and (2) issue interim final rules, with a request for comment, that address the treatment under sections 23A and 23B of credit exposure arising from derivatives and intraday credit extensions, as required by the Gramm-Leach-Bliley Act (“GLB Act”).

BACKGROUND: Sections 23A and 23B of the Federal Reserve Act impose restrictions on a bank’s loans to, purchases of assets from, and certain other transactions with, affiliates.² Section 23A originally was enacted as part of the Banking Act of 1933, and applied only to banks that were members of the Federal Reserve System.

The original intent of the legislation was to prevent the misuse of a bank’s resources stemming from large-scale, “non-arm’s-length” loans to bank affiliates. The law also limits the ability of a bank to transfer to its affiliates the subsidy arising from the bank’s access to the federal safety net. Since 1933, Congress has amended the statute several times, including a comprehensive revision in 1982, at the Board’s recommendation. Congress extended section 23A to cover insured nonmember banks in 1966 and to

¹ Legal (Messrs. Mattingly, Alvarez, and Fallon, Ms. Nardolilli, and Mr. Van Der Weide); BS&R (Mr. Martinson and Ms. Wassom); R&S (Messrs. Ettin and Parkinson); Federal Reserve Bank of New York (Messrs. Hendricks, Gormley, and Keogh and Ms. Virzera).

² 12 U.S.C. §§ 371c & 371c-1.

cover insured thrifts in 1989. In 1987, Congress enacted section 23B of the Federal Reserve Act, which requires that transactions between a bank and its affiliates be on market terms.

Overview of Section 23A's Provisions

Section 23A seeks to achieve its goals in three major ways. First, it prohibits a bank from making a loan to, or initiating any other “covered transaction” with, an affiliate if, after the transaction, (i) the aggregate amount of the bank’s covered transactions with any single affiliate would exceed 10 percent of the bank’s capital stock and surplus, or (ii) the aggregate amount of the bank’s covered transactions with all affiliates would exceed 20 percent of the bank’s capital stock and surplus. Covered transactions include loans and other extensions of credit to an affiliate, investments in the securities of an affiliate, purchases of assets from an affiliate, and certain other transactions that expose the bank to the financial risks of its affiliates.

Second, the statute requires all covered transactions between a bank and its affiliates to be on terms and conditions that are consistent with safe and sound banking practices, and prohibits a bank from purchasing low-quality assets from its affiliates. Finally, the statute requires that a bank’s extensions of credit to affiliates be appropriately secured by a statutorily defined amount of collateral.

Overview of Section 23B's Provisions

Section 23B protects a bank by requiring that transactions between the bank and its affiliates occur on market terms.³ Section 23B applies this

³ In particular, section 23B provides that a bank may engage in transactions with an affiliate “only (A) on terms and under circumstances, including credit standards, that are substantially the same as, or at least as favorable to

restriction to any covered transaction (as defined in section 23A) with an affiliate as well as certain other transactions, including (i) a sale of securities or other assets by the bank to an affiliate; (ii) any payment of money or furnishing of services by the bank to an affiliate under contract, lease, or otherwise; and (iii) any transaction in which an affiliate acts as an agent or broker to the bank or to any other person if the bank is a participant in the transaction.

Reasons for Proposing Regulation W

Although compliance with sections 23A and 23B is enforced by the four federal banking agencies independently, both sections provide the Board with explicit authority to issue regulations “to administer and carry out the purposes of” the statute. Accordingly, banks and the other federal banking agencies have looked principally to the Board for guidance in interpreting and applying sections 23A and 23B. To date, the Board has provided this guidance through a series of Board interpretations and staff letters and informal opinions. The Board has not adopted a comprehensive regulation to implement sections 23A and 23B.

Staff now believes that adoption of a comprehensive regulation implementing sections 23A and 23B would be appropriate for several reasons. First, the new regulatory framework established by the GLB Act emphasizes the importance of sections 23A and 23B as a means to protect banks from losses in connection with the newly authorized affiliates.

such [bank], as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or (B) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies.” 12 U.S.C. § 371c-1(a)(1).

In addition, the GLB Act amended section 23A in several important respects. For example, the GLB Act requires the Board to adopt final rules, by May 12, 2001, to address credit exposure on derivative transactions and intraday credit extensions under section 23A. The GLB Act also applies section 23A to financial subsidiaries of banks, and several questions have arisen concerning the application of section 23A to these companies.

Moreover, adoption of a comprehensive regulation would allow the Board to place together in a single public document the various Board interpretations and staff opinions relating to the statute that have been issued over the years. The regulation would simplify for banking organizations the task of complying with the sections and would help ensure that the sections are consistently interpreted and applied by the federal banking agencies and the industry.

Finally, issuing a proposed regulation would allow the public an opportunity to comment on Board and staff interpretations of sections 23A and 23B, many of which were adopted without the benefit of a public comment process. Although the Board adopted several of these interpretations after public comment, the Board has not reviewed these positions for many years, and fresh public comment on their appropriateness, as well as on the staff guidance relating to sections 23A and 23B, would be worthwhile.

Staff has drafted a proposed Regulation W that implements the provisions of sections 23A and 23B. The draft regulation and Federal Register notice accompanying the regulation are attached hereto as Appendix B. The regulation confirms numerous traditional Board and staff interpretations of the statute, revises other previous staff opinions on the

statute, proposes several additional exemptions from the requirements of the statute, and addresses several new topics under sections 23A and 23B.

Interim Final Rules on Derivatives and Intraday Extensions of Credit

As noted above, the GLB Act requires that the Board adopt, by May 12, 2001, a final rule addressing under section 23A the credit exposure arising out of derivative transactions between banks and their affiliates and intraday extensions of credit by banks to their affiliates. In light of this statutory deadline, staff recommends that the Board adopt interim final rules, which are attached as Appendix C, concerning credit exposure on derivative transactions and intraday extensions of credit. As discussed further below, the interim rules would require that banks maintain policies and procedures to manage the credit exposure to affiliates arising from derivative transactions and intraday extensions of credit. Staff also recommends that the Board seek public comment in the broader Regulation W rulemaking process on how these types of transactions should be treated under section 23A.

The next section of this memorandum provides an explanation of the major issues addressed by Regulation W and the interim final rules and staff's proposed resolution of those issues. Other issues addressed in the proposed Regulation W are described in Appendix A.

Staff anticipates that the Board will receive a substantial amount of public comment on the proposed Regulation W and the interim final rules due to the importance of the issues addressed by these rules.

DISCUSSION: The proposed Regulation W and the interim final rules to be issued concurrently with Regulation W would address a variety of issues raised by the GLB Act and by long-standing provisions of sections 23A and

23B. This memorandum discusses the following eight significant issues raised by the regulations:

- credit exposure on derivative transactions between banks and their affiliates (pp. 7 to 14);
- credit exposure on intraday credit extensions by banks to their affiliates (pp. 14 to 17);
- the 250.250 exemption permitting a bank to purchase loans from an affiliate (pp. 17 to 19);
- valuation of a bank's investments in, and acquisitions of, affiliates (pp. 19 to 25);
- collateralization of a bank's investment in the debt securities (including commercial paper) of an affiliate (pp. 25 to 27);
- application of sections 23A and 23B to the U.S. branches and agencies of foreign banks (pp. 27 to 31);
- treatment of financial subsidiaries (pp. 31 to 32); and
- new proposed exemptions (pp. 32 to 33).

A. Derivative Transactions

Derivative transactions between a bank and its affiliates generally arise either from the risk management needs of the bank or the affiliate. Transactions arising from the bank's needs typically arise when a bank enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract or is unable to hedge the risk directly because the bank is not authorized to hold the hedging asset. In order to manage the market risk, the bank may have an affiliate acquire the hedging asset. The bank would then do a "bridging" derivative transaction between itself and the affiliate maintaining the hedge.

Most of these bank-initiated derivative transactions with affiliates are equity derivatives.

Other derivative transactions between a bank and its affiliate are affiliate-driven. A bank's affiliate may enter into an interest-rate or foreign-exchange derivative with the bank in order to accomplish the asset-liability management goals of the affiliate. For example, a bank holding company may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The holding company may then enter into a fixed-to-floating interest-rate swap with its subsidiary bank to reduce the holding company's interest-rate risk.

Staff notes that some derivative transactions -- like deep in-the-money options or swaps with an exchange of principal on different dates -- are the functional equivalent of a loan, which is an explicit type of covered transaction under section 23A. Other derivatives are the functional equivalent of a guarantee, which is another type of transaction expressly covered by section 23A. Although staff is not aware that banks and their affiliates are entering into these types of derivative transactions, the Board may need to address these derivatives separately from the other types of derivatives because of their functional equivalence to an existing type of covered transaction under the statute.

Banks and their affiliates that seek to enter into derivative transactions for hedging (or risk-taking) purposes could enter into the desired derivatives with unaffiliated companies. Banks and their affiliates often choose to use each other as their derivative counterparties, however, in order to maximize the profits of and manage risks within the consolidated financial group.

Although the Board has not previously ruled on the question of whether bank-affiliate derivative transactions are subject to the market terms

requirement of section 23B, staff believes that such transactions are subject to section 23B under the express terms of the statute.⁴ Staff understands, based on a limited survey, that many of the larger banks that engage in derivative transactions with their affiliates do so in accordance with the market terms requirement of section 23B.

The Board also has not previously ruled on the question of whether bank-affiliate derivative transactions are covered transactions under section 23A. Although industry practice does not treat these transactions as subject to section 23A, derivative transactions between a bank and an affiliate resemble section 23A covered transactions in many respects. Such transactions may expose banks to the credit risk of their affiliates. Although the typical bank-affiliate derivative transaction does not create current credit exposure for the bank at the inception of the transaction, a bank may incur current credit exposure to an affiliate during the term of a derivative transaction and nearly always faces some amount of potential future exposure on such a transaction. The credit exposure on a derivative transaction with an affiliate poses a risk to the safety and soundness of the bank that is similar in many respects to the risk posed by a loan to an affiliate, and may be more volatile and indeterminate than the credit exposure created by a loan.

Determining the appropriate treatment for derivative transactions under section 23A is a complex and important endeavor. In light of the

⁴ In addition to applying to covered transactions as defined in section 23A, the market terms requirement of section 23B applies broadly to, among other things, “[t]he payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise.” 12 U.S.C. 371c-1(a)(2)(C). Bank-affiliate derivatives generally involve a contract or agreement to pay money to the affiliate or furnish risk management services to the affiliate.

complexities of the subject matter and in light of the May 12, 2001, statutory schedule in the GLB Act, staff recommends that the Board take the following two steps to address the credit exposure arising from bank-affiliate derivative transactions under section 23A.

First, staff recommends that the Board publish an interim final rule (concurrently with the proposed Regulation W) that requires, under section 23A, as amended by the GLB Act, that a bank establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from the bank's derivative transactions with affiliates. The policies and procedures must at a minimum provide for monitoring and controlling the credit exposure arising from the bank's derivative transactions with affiliates and ensuring that the bank's derivative transactions with affiliates comply with section 23B. The interim rule also defines the term "derivative transaction" to mean any derivative contract covered by the Board's capital adequacy guidelines (which includes most interest-rate, currency, equity, and commodity derivative contracts) and any similar derivative contract, including certain credit derivative contracts.⁵ The interim final rule would have a delayed effective date of January 1, 2002.

The interim final rule also would state the Board's view that bank-affiliate derivative transactions are subject to the market terms requirement of section 23B. To comply with section 23B, each bank should have in place credit limits on its derivatives exposure to affiliates that are at least as

⁵ Staff recommends that the Board interpret section 23A to provide that credit derivatives between a bank and an unaffiliated company that reference the obligations of an affiliate of the bank and are the functional equivalent of a guarantee by the bank on behalf of an affiliate would be fully subject to section 23A as covered transactions.

strict as the credit limits the bank imposes on unaffiliated companies that are engaged in similar businesses and are substantially equivalent in size and credit quality. Similarly, each bank should monitor derivatives exposure to affiliates in a manner that is at least as rigorous as it uses to monitor derivatives exposure to comparable unaffiliated companies. In addition, each bank should price, and require collateral in, derivative transactions with affiliates in a way that is at least as favorable to the bank as the way the bank would price, or require collateral in, a derivative transaction with comparable unaffiliated counterparties.

The second step that staff recommends that the Board take to address credit exposure on bank-affiliate derivative transactions under section 23A is to ask for public comment in the Federal Register notice accompanying Regulation W on a set of questions regarding the appropriate treatment of these transactions under section 23A. Solicitation of public comment in connection with Regulation W on measures in addition to those described above that should govern bank-affiliate derivatives would assist the Board in ultimately deciding how to address such derivatives under section 23A. The Federal Register notice would make clear that the Board would not take additional steps toward addressing bank-affiliate derivatives without seeking further public comment on a concrete proposal.

Although staff continues to explore and analyze the complex issue of how best to address bank-affiliate derivative transactions under section 23A, staff does not recommend at this time that the Board subject credit exposure arising from derivatives to all the requirements of section 23A. Staff continues to collect information regarding the derivatives practices of banks, and the interim rule would ask for additional data on such practices in order to assist the Board in determining whether the approach set forth in the

interim rule would suffice to prevent banks from incurring material credit exposure to affiliates on derivative transactions. It appears from the limited information available that several of the larger banks that participate in the derivatives markets increasingly manage credit risk arising from derivatives exposure to financial institutions by requiring such counterparties to post collateral. These banks generally require full collateralization of their current credit exposure (i.e., positive net mark-to-market values recalculated daily based on the previous day's exposures) on derivative transactions with financial institutions above a relatively small threshold amount.

Despite the emerging best market practices in this area, section 23B may not be sufficient in all cases to protect banks from credit exposure arising from their derivative transactions with affiliates because section 23B does not mandate that each bank use best market practices in dealing with its affiliates. Moreover, there are difficulties in applying the comparative analysis required by section 23B. Accordingly, staff believes that the Board may need to subject the credit exposure arising from bank-affiliate derivative transactions to section 23A.

To help determine whether to cover these transactions under section 23A and, if so, the appropriate extent of coverage, the preamble to Regulation W would seek comment on a set of questions regarding how the Board should address these transactions under section 23A. First, staff recommends that the Board seek comment on how to determine when a derivative transaction, such as a deep in-the-money option purchased by a bank from an affiliate, is the functional equivalent of a loan from the bank to an affiliate and, accordingly, fully subject to section 23A. Similarly, staff recommends that the Board seek comment on how to treat a derivative transaction that effectively guarantees to a nonaffiliate the credit or

performance of an affiliate. Staff also recommends that the Board seek comment on the appropriate treatment under section 23A for credit derivatives between a bank and an affiliate of the bank that reference third-party obligations held by the affiliate.

Second, staff recommends that the Board ask whether banks should be required to adopt any specific types of policies and procedures with respect to their derivative transactions with affiliates. These policies and procedures might include provisions that require a bank to adopt the following “best practices”: (i) entering into a legally enforceable bilateral netting agreement with each of its affiliated derivatives counterparties; (ii) revaluing its derivative transactions with affiliates on a daily basis; and (iii) collateralizing its net mark-to-market exposure on derivative transactions with affiliates.

Third, staff recommends that the Board solicit comment on whether banks should be required to disclose to federal bank supervisors or the public, on a quarterly or other periodic basis, their net credit exposure to affiliates on derivative transactions.

Fourth, staff recommends that the Board invite comment on whether to impose a quantitative limit on the aggregate amount of a bank’s net credit exposure on derivative transactions with affiliates. The limit could be structured as a separate limit for net credit exposure on bank-affiliate derivative transactions or could require banks to incorporate net credit exposure arising from their derivative transactions with affiliates into their overall section 23A quantitative limits.

Fifth, staff recommends that the Board ask whether banks should be required to collateralize their net derivatives credit exposure to affiliates in accordance with the collateral requirements of section 23A.

Finally, because the Board may decide to impose a quantitative limit on bank-affiliate derivative transactions (whether by establishing a separate limit for derivatives or by requiring banks to include derivatives in their overall section 23A limits), staff recommends that the Board seek comment on how banks should be required to determine the amount of their derivative transactions with affiliates and, in particular, whether and how banks should be required to include an estimate of their potential future exposure to affiliates on such transactions. Staff also proposes that the Board ask for comment on whether and how banks should be allowed to take collateral into account in determining the amount of their derivative transactions with affiliates. In addition, the Board should ask whether to ignore for section 23A purposes the uncollateralized derivatives exposure of a bank to its affiliates underneath a certain threshold amount.

B. Intraday Extensions of Credit

As noted above, the GLB Act requires the Board to adopt, by May 12, 2001, a final rule to address as covered transactions under section 23A the credit exposure arising from intraday extensions of credit by banks to their affiliates. Banks regularly provide transaction accounts to their affiliates in conjunction with providing payment and securities clearing services. As in the case of unaffiliated commercial customers, these accounts are subject to overdrafts during the day that are repaid in the ordinary course of business. The Board has not to date ruled on whether these or other types of intraday credit extensions are covered transactions under section 23A or are subject to the market terms requirement of section 23B. Industry practice does not

treat an intraday credit extension as subject to sections 23A or 23B unless the extension remains outstanding at the end of the day.⁶

Existing business practices indicate that the potential risk reduction benefits afforded by full application of the requirements of section 23A to intraday credit exposures may not justify the costs to banking organizations of implementing these requirements at this time. Intraday overdrafts and other forms of intraday credit extensions are generally not used as a means of funding or otherwise providing financial support for an affiliate. Rather, these credit extensions typically facilitate the settlement of transactions between an affiliate and its customers when there are mismatches between the timing of funds sent and received during the business day. Although some risk exists that such intraday credit extensions could turn into overnight funding of an affiliate, this risk may be sufficiently remote that application of the strict collateral and other requirements of section 23A would not be warranted for the intraday credit exposure. Moreover, mandating that banks collateralize intraday exposures could require banks to measure exposures across multiple accounts, offices, and systems on a global basis and to adjust collateral holdings in real time throughout the day. Staff is concerned that few banks currently have these capabilities and that they would be very costly to implement.

In light of these considerations, staff recommends that the Board take a two-step approach to address intraday extensions of credit from a bank to an affiliate under sections 23A and 23B that is similar to the proposed approach for bank-affiliate derivative transactions. First, staff recommends

⁶ The text of section 23A in no way suggests that a transaction must extend overnight to qualify as an extension of credit.

that the Board publish an interim final rule that (i) requires, under section 23A, that a bank establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from the bank's intraday extensions of credit to affiliates and (ii) clarifies that intraday extensions of credit by a bank to an affiliate are subject to the market terms requirement of section 23B. The policies and procedures must at a minimum provide for monitoring and controlling the bank's intraday credit exposure to affiliates and ensuring that the bank's intraday credit extensions to affiliates comply with section 23B. This interim final rule would have a delayed effective date of January 1, 2002.

Second, staff recommends that the Board request comment on a more detailed proposed rule on intraday credit extensions by banks to affiliates in Regulation W. Regulation W would provide that an intraday credit extension is not subject to the quantitative limits or collateral requirements of section 23A if the credit extension arises in connection with the performance by a bank, in the ordinary course of business, of securities clearing and settlement transactions or payment transactions (e.g., wire transfers, check clearing, and ACH transactions) on behalf of an affiliate, and the bank (i) has no reason to believe that the affiliate will have difficulty repaying the extension of credit at the end of the day; (ii) establishes limits on the net amount of intraday credit that the bank may extend to affiliates; and (iii) maintains policies and procedures for monitoring each affiliate's compliance with the limits.

Intraday extensions of credit by a bank to an affiliate that do not meet these conditions would be subject to the quantitative, collateral, and other requirements of section 23A. In addition, as under current practice, all intraday credit extensions that exist at the end of the bank's business day

would become subject to section 23A at that time. The proposal would seek comment on whether the Board should find that other types of intraday credit, not related to payment and securities clearing transactions, should be exempt from the quantitative limits and collateral requirements of section 23A.

Staff ultimately may recommend adopting a different approach to intraday extensions of credit under section 23A if it finds that banks are not implementing satisfactory controls to manage, monitor, and control intraday credit exposure to affiliates.

C. The “250.250” Exemption⁷

Section 23A, by its terms, exempts certain transactions from its requirements and authorizes the Board to grant additional exemptions. For example, the statute exempts transactions between sister banks and transactions fully secured by U.S. government securities from most of section 23A’s requirements. Regulation W would provide several additional exemptions, some of which the Board has adopted previously by interpretation, some of which the Board has issued previously in proposed form, and some of which are new. The most significant of these non-statutory exemptions -- the so-called “250.250 exemption” -- is discussed in this section. The other additional regulatory exemptions are described in section H of this part of the memorandum, in Appendix A to the memorandum, and in the memorandum accompanying this item.

In 1979, the Board issued a formal interpretation (codified at 12 C.F.R. 250.250) that exempts a bank’s purchase of a loan from an affiliate if (i) the bank makes an independent evaluation of the creditworthiness of the

⁷ See § 223.16(j) of Regulation W.

borrower before the affiliate makes the loan, and (ii) the bank commits to purchase the loan prior to the affiliate making the loan. Although the 1979 interpretation did not impose a strict dollar limit on the amount of an affiliate's loans that a bank could purchase under this exemption, the interpretation cautioned that the purpose of the exemption was to allow a bank to take advantage of an investment opportunity and not to provide all the working capital needed by an affiliate.

By 1995, some bank holding companies were using the 250.250 exemption extensively to fund their lending affiliates. In these cases, banks were providing all or nearly all of their affiliates' funding needs. In response, staff indicated in an interpretive letter that the 250.250 exemption was not available if the dollar amount of the bank's purchases from the affiliate represented more than 50 percent of the total dollar amount of loans made by the affiliate.⁸ Staff reasoned that, in these circumstances, the asset purchases look less like the bank taking advantage of an investment opportunity brought to it by the affiliate and more like the bank providing an ongoing funding mechanism for the affiliate. Staff intended that this restriction would require the affiliate to have alternative funding sources and reduce the pressure on the bank to purchase the affiliate's extensions of credit.

Staff recommends that the Board seek comment on whether to incorporate this interpretation of the 250.250 exemption into Regulation W. Staff also proposes that the Board solicit comment on whether to supplement the bright-line 50 percent test with a requirement that the bank not provide

⁸ Letter dated April 24, 1995, from J. Virgil Mattingly, Jr., General Counsel of the Board, to William F. Kroener, III, Federal Deposit Insurance Corporation.

“substantial, ongoing funding” to the affiliate. Although this supplemental standard may create some uncertainty for banks, the standard would provide examiners with additional flexibility to stop arrangements in which a bank provides a significant amount of funding to an affiliated lending company but does not provide a majority of the affiliate’s working capital.

Staff also recommends that the Board seek comment on whether to limit the amount of assets that a bank may purchase from an affiliate pursuant to the 250.250 exemption to some percentage of the bank’s total assets. The Board recently reviewed a case where a nonbanking company proposed to charter a bank for the sole purpose of purchasing loans or leases from the nonbanking company. In these circumstances, a bank’s credit underwriting process may be compromised as a result of the complete dependence of the bank on the affiliate for asset growth. Prohibiting a bank from using the 250.250 exemption to accumulate a large percentage of its assets may help prevent such compromises.

D. Valuation of a Bank’s Investments in, and Acquisitions of, Affiliates

Regulation W would provide rules for banks to follow in valuing the various types of covered transactions for purposes of determining compliance with section 23A’s quantitative limits and collateral requirements. Two valuation rules in particular may generate comment from banking organizations: (i) rules for the valuation of a bank’s investment in the securities of an affiliate; and (ii) rules for the valuation of the contribution of an affiliate to a bank where the affiliate becomes an operations subsidiary of the bank after the transaction. The rules for valuing these types of transaction are different because the contributed company remains an affiliate of the bank after the first described transaction, while the contributed company is an operations subsidiary of the bank (and no longer

an affiliate of the bank) after the second described transaction. As discussed below, section 23A treats transactions with operations subsidiaries of a bank differently than transactions with affiliates of a bank.

1. Valuing an Investment in Securities Issued by an Affiliate⁹

Section 23A includes as a covered transaction a bank's purchase of, or investment in, securities issued by an affiliate. Regulation W would require a bank to value a purchase of, or investment in, securities issued by an affiliate (other than a financial subsidiary, which is subject to special rules under the GLB Act) at the greater of the bank's purchase price or carrying value of the securities. Under the rule, a bank that pays no consideration in exchange for affiliate securities must nevertheless value the covered transaction at no less than the bank's carrying value for the securities.¹⁰ In addition, under the rule, if the bank's carrying value of the affiliate securities increased or decreased after the bank's initial investment (due to profits or losses at the affiliate), the amount of the bank's covered transaction would increase or decrease to reflect the bank's changing financial exposure to the affiliate, but could not decline below the amount paid by the bank for the securities.

Staff believes several considerations support the approach contained in the proposed regulation. First, the approach is generally consistent with GAAP, which would require the bank to reflect its investment in securities issued by an affiliate at carrying value throughout the life of the investment, even if the bank paid no consideration for the securities. Second, the

⁹ See § 223.10 of Regulation W.

¹⁰ Carrying value refers to the amount at which the securities are carried on the GAAP financial statements of the bank.

approach is supported by the terms of the statute, which defines both a “purchase of” and an “investment in” securities issued by an affiliate as a covered transaction. The statute’s “investment in” language indicates that Congress was concerned with a bank’s continuing exposure to an affiliate through an ongoing investment in the affiliate’s securities.

Third, amendments to section 23A made by the GLB Act support staff’s proposed valuation rule for these transactions. The GLB Act defines a financial subsidiary of a bank as an affiliate of the bank, but specifically provides that the section 23A value of a bank’s investment in the securities of a financial subsidiary does not include retained earnings of the subsidiary. The negative implication from this provision is that the section 23A value of a bank’s investment in other affiliates includes the affiliates’ retained earnings, which would be reflected in the bank’s carrying value of the investment under the rule.

Finally, this valuation rule is consistent with the purposes of section 23A -- limiting the financial exposure of banks to their affiliates and promoting safety and soundness. The proposed rule would require a bank to revalue upwards the amount of an investment in affiliate securities only when the bank’s exposure to the financial condition of the affiliate has increased (as reflected on the bank’s financial statements) and the bank’s capital has increased to reflect the higher value of the investment. In these circumstances, the valuation rule merely reflects the bank’s greater financial exposure to the affiliate and promotes safety and soundness by reducing the bank’s ability to engage in additional transactions with an affiliate as the bank’s exposure to that affiliate increases.

As noted above, the proposed rule provides that the section 23A value of a bank’s investment in affiliate securities can be no less than the amount

paid by the bank for the securities, even if the carrying value of the securities declines below that amount. Staff believes that this approach, although not consistent with GAAP, is reasonable because it establishes as a floor the amount of funds actually paid by the bank for the affiliate securities. Using the bank's purchase price for the securities as a floor for valuing the covered transaction also limits the ability of a bank to provide additional funding to an affiliate as the affiliate approaches insolvency. If the regulation were to value investments in securities issued by an affiliate strictly at carrying value, then the bank could lend more funds to the affiliate as the affiliate's financial condition worsened, because the carrying value of the affiliate's securities also would decline and thereby increase the bank's ability to provide additional funding under section 23A. This type of increasing support for an affiliate in distress is precisely what section 23A was intended to restrict.

2. Valuing the Contribution of an Affiliate to a Bank¹¹

A second issue arises when a holding company contributes all of the shares of an affiliate to a subsidiary bank, thereby making the contributed company a subsidiary (and no longer an affiliate) of the bank for section 23A purposes. The Board has viewed this type of transaction as a purchase of assets of an affiliate by the bank and, thus, a covered transaction under section 23A, and the proposed regulation would continue this approach.

Although the Board has considered such a contribution of an affiliate to be a purchase of assets, the bank involved typically pays no money in exchange for the affiliate's shares, and the Board traditionally has not

¹¹ See § 223.12 of Regulation W.

required the bank to treat the transaction as a covered transaction under section 23A unless the contributed company has liabilities to another affiliate at the time of the transaction. In these circumstances, the Board has treated the contribution as if the bank purchased assets from an affiliate at a purchase price equal to the liabilities owed by the contributed company to other affiliates of the bank.¹²

Regulation W, however, would require the bank to value this type of contribution of an affiliate based on the total amount of liabilities owed by the contributed affiliate to any person. In effect, the rule requires a bank to treat this sort of share donation in the same manner as if the bank had directly purchased the assets of the transferred affiliate at a purchase price equal to the total liabilities of the transferred affiliate.

Staff believes that this approach is consistent with the approach that section 23A takes on subsidiaries of banks and with economic and marketplace realities. Section 23A treats banks and their operations subsidiaries as a single unit. Transactions between a bank and its operations subsidiaries are not treated as covered transactions between a bank and an affiliate under section 23A; rather, they are treated as transactions entirely

¹² Some banking organizations have argued that this treatment is too strict and that a covered transaction should be deemed to occur in connection with an affiliate share contribution only if there is a net transfer of value from the bank to the affiliate (that is, if the liabilities of the transferred company exceed the value of the assets of the company). In many such internal corporate reorganizations, staff has found that the value of the assets of the transferred company was uncertain. In addition, the transactions often were motivated by funding problems at the transferred affiliate and by a desire to use the bank's resources to alleviate those funding needs. Soon after consummating such reorganizations, bank funds typically were used to pay down liabilities that the transferred company had to the parent holding company of the bank.

inside the bank. Similarly, a transaction between a bank's operations subsidiary and an affiliate of the bank is treated as a covered transaction between the bank itself and an affiliate under section 23A.

Because a bank and its subsidiaries are treated as a single unit under section 23A, viewing a transaction in which an affiliate becomes a subsidiary of the bank as a purchase of an affiliate's assets and an assumption of an affiliate's liabilities by the bank is consistent with the structure of section 23A. This is especially true because after the transaction the bank could merge the newly acquired subsidiary directly into itself outside the scope of section 23A.

This approach is also consistent with staff's supervisory experience. Staff has found that banks often operate their consolidated organizations -- because of capital requirements, financial reporting requirements, and reputational risk concerns -- as if the assets and liabilities of subsidiaries were actually assets and liabilities of the bank itself. Banks often attempt to shore up their subsidiaries in times of financial stress, despite the limited liability inhering in the corporate form.

Staff notes that the potential impact of this approach may be limited. The Board has granted numerous section 23A exemptions, on a case-by-case basis, for transfers of an affiliate to a bank where the affiliate becomes an operations subsidiary of the bank after the transfer. The Board typically has approved such exemptions only if certain conditions are met, including (i) the transfer of the affiliate must be the result of a one-time corporate reorganization, (ii) the entity transferring the affiliate to the bank must make certain asset quality assurances, (iii) the disinterested directors of the bank must approve the transaction in advance, (iv) any low-quality assets must have been removed from the affiliate prior to the transaction; and (v) the

bank's appropriate federal banking agency and the Federal Deposit Insurance Corporation must inform the Board that they have no objection to the transaction. Staff expects that banks would continue to apply to the Board for such exemptions and that the Board would continue to grant such exemptions in appropriate cases.

E. Purchase of Commercial Paper or Other Debt Securities of an Affiliate¹³

The definition of covered transaction in section 23A includes both a loan or extension of credit by a bank to an affiliate and a bank's purchase of or investment in securities issued by an affiliate. The statute explicitly provides that a bank must collateralize its loans and extensions of credit to an affiliate, but does not explicitly require a bank to collateralize its purchases of or investments in the securities of an affiliate.

Regulation W would clarify that a bank's purchase of a debt security, including commercial paper, issued by an affiliate is considered both an investment by the bank in securities issued by an affiliate and an extension of credit by the bank to the affiliate for purposes of section 23A. Staff is aware that some banks have purchased or have proposed to purchase the commercial paper of their holding companies, and have done so or proposed to do so without collateralizing the purchase. These banks have argued that a purchase of commercial paper is a "purchase of or investment in securities issued by an affiliate" for purposes of section 23A, and that such a purchase cannot also then be an "extension of credit" for purposes of section 23A and its collateral requirements.

Although section 23A's definition of covered transaction separately includes a bank's purchase of securities issued by an affiliate and a bank's

¹³ See § 223.26(j)(3) of Regulation W.

extension of credit to an affiliate, there is no indication that the identified types of covered transaction in the statute were intended to be mutually exclusive. In staff's view, the fact that a holder of debt securities expects repayment of principal upon maturity makes debt securities closely resemble loans for purposes of section 23A and the statute's objective of protecting the bank. Therefore, the proposed regulation provides that a bank that buys debt securities issued by an affiliate also has made an extension of credit to an affiliate under section 23A and must collateralize the transaction in accordance with the statute's collateral requirements applicable to extensions of credit.

Staff recommends that the Board seek comment on whether the rule should permit banks in certain circumstances to purchase debt securities issued by an affiliate without satisfying the collateral requirements of section 23A. In particular, staff proposes that the Board ask whether to require section 23A collateralization in circumstances where a bank purchases an affiliate's debt securities (i) from a third party in a bona fide secondary market transaction; or (ii) pursuant to a registered public offering document or a private placement memorandum in an offering in which the affiliate receives significant participation from third parties. In these circumstances, the risk that a bank's purchase of an affiliate's debt securities is designed to shore up an ailing affiliate may be reduced. Moreover, in both of these situations, the purchase of affiliate debt securities would be subject to the quantitative limits of section 23A and the market terms requirement of section 23B.

F. Foreign Banks¹⁴

Sections 23A and 23B by their terms do not apply to the U.S. branches and agencies of foreign banks because such entities are neither member banks nor insured depository institutions. Section 114 of the GLB Act explicitly authorizes the Board, however, to impose restrictions on transactions between a U.S. branch, agency, or commercial lending company of a foreign bank and any affiliate in the United States of such foreign bank that the Board finds are appropriate to prevent, among other things, decreased or unfair competition or a significant risk to the safety and soundness of depository institutions.

The Board has for years imposed certain of the requirements of sections 23A and 23B on transactions between a U.S. branch or agency of a foreign bank and its U.S. affiliates engaged in underwriting and dealing in bank-ineligible securities (“section 20 affiliates”).¹⁵ The Board also recently applied sections 23A and 23B to transactions between a U.S. branch or agency of a foreign bank and affiliates conducting merchant banking activities under the GLB Act and portfolio companies held under that authority.

¹⁴ See § 223.23 of Regulation W.

¹⁵ The Board’s Operating Standards for section 20 affiliates require (i) any intraday extensions of credit by a U.S. branch or agency of a foreign bank to its section 20 affiliates to comply with the market terms requirement of section 23B; (ii) any extensions of credit by a U.S. branch or agency of a foreign bank to its section 20 affiliates and any purchase by such branch or agency of securities for which a section 20 affiliate is the principal underwriter to comply with sections 23A and 23B; and (iii) a U.S. branch or agency of a foreign bank to refrain from advertising or suggesting that it is responsible for the obligations of a section 20 affiliate, consistent with section 23B(c). See 12 C.F.R. 225.200.

Regulation W would fully apply sections 23A and 23B to covered transactions between a U.S. branch or agency of a foreign bank and any affiliate of such foreign bank directly engaged in the United States in the following financial activities newly authorized under the GLB Act:

- non-credit-related insurance underwriting;
- full-scope securities underwriting and dealing;
- merchant banking; and
- insurance company investment activities.¹⁶

The regulation also would apply sections 23A and 23B to transactions between a U.S. branch or agency of a foreign bank and any portfolio company controlled by the foreign bank under the GLB Act's merchant banking or insurance company investment authorities. The regulation would not apply sections 23A or 23B to transactions between a U.S. branch or agency and any other type of affiliate (e.g., foreign affiliates or U.S. affiliates engaged in nonbanking activities under section 4(c)(8) of the BHC Act), or to transactions between the foreign bank's non-U.S. offices and its U.S. affiliates.

Applying the restrictions of sections 23A and 23B to transactions between the U.S. branches and agencies of foreign banks and the indicated U.S. affiliates may help to ensure maintenance of a competitive playing field between U.S. banks and foreign banks operating in the United States. The issue of competitive equity arises most strongly in connection with those

¹⁶ The regulation permits U.S. branches and agencies of foreign banks to compute their section 23A "capital stock and surplus" by reference to the capital of the foreign bank. This is generally consistent with the approach taken by the Board in its section 20 Operating Standards and in its merchant banking rule.

activities that a U.S. bank cannot engage in directly or through an operations subsidiary. A U.S. bank may affiliate itself with a company engaged in the newly authorized financial activities listed above only if the company is a holding company affiliate of the bank or, in some cases, a financial subsidiary of the bank.¹⁷ In either case, covered transactions between the U.S. bank and the company would be subject to sections 23A and 23B. Without Regulation W's extension of the scope of these statutory provisions, a foreign bank's U.S. branch or agency could fund and engage in transactions with these types of affiliates more freely than could a U.S. bank. To the extent that a foreign bank's U.S. branches and agencies are able to fund these types of U.S. affiliates outside of the restrictions of sections 23A and 23B, the affiliates are able to compete for business in the United States with a potential advantage not available to the affiliates of U.S. banks.

Staff does not believe that it is appropriate or necessary at this time to impose the requirements of sections 23A and 23B on transactions between a foreign bank's U.S. branch or agency and its U.S. affiliates that are engaged only in activities that were permissible for bank holding companies before the passage of the GLB Act (other than section 20 affiliates). Staff recognizes the hardship this might impose on foreign banks conducting such activities in the United States under previous law. Moreover, most of these activities may be conducted by a U.S. bank directly (or in an operations

¹⁷ Regulation W, consistent with the merchant banking rule, would impose sections 23A and 23B on a covered transaction between a U.S. branch or agency of a foreign bank and its U.S. merchant banking affiliate only to the extent the proceeds of the covered transaction are used for the purpose of funding the affiliate's merchant banking activities.

subsidiary) and, hence, may be funded by the bank in a manner that is not subject to sections 23A and 23B.

Staff notes, in addition, that the potential scope, nature, and risk of transactions and relationships between U.S. branches and agencies of foreign banks and their affiliates engaged in the United States in insurance underwriting, full-scope securities underwriting and dealing, merchant banking, and insurance company investment is unclear at this time. At least until such time as the Board acquires more information and supervisory experience regarding these transactions and relationships, applying sections 23A and 23B may help ensure competitive equity between foreign banks and U.S. banking organizations in the funding of certain of their U.S. nonbank operations.

G. Financial Subsidiaries¹⁸

The GLB Act authorized banks to control a new type of subsidiary, called a financial subsidiary, that may engage in financial activities that are not permissible for the parent bank to conduct directly. Regulation W specifically provides, consistent with the GLB Act, that a financial subsidiary of a bank is an affiliate of the bank for purposes of sections 23A and 23B.

The rule includes a definition of financial subsidiary that is identical to the definition of the term set forth in section 23A, as amended by the GLB Act. Section 23A defines a financial subsidiary as any subsidiary of a bank that would be a financial subsidiary of a national bank. The National Bank Act defines a financial subsidiary as a subsidiary of a bank that engages in an activity that national banks are not permitted to engage in directly (other

¹⁸ See § 223.26(k) of Regulation W.

than a subsidiary that a national bank is explicitly authorized to control by statute).

State banks may directly engage in certain activities that a national bank cannot engage in directly -- for example, general insurance agency activities in any location. In addition, a few state banks have subsidiaries that engage in real estate investment and development activities -- activities that are prohibited to national banks and financial subsidiaries of national banks. Staff recommends that the Board ask for comment on whether the definition of financial subsidiary should be read to include either a subsidiary of a state bank that engages solely in activities that the parent bank is permitted to engage in directly (but that a national bank may not conduct directly) or a real estate investment and development subsidiary of a state bank.

H. New Exemptions¹⁹

Regulation W contains several new exemptions from section 23A, including several exemptions proposed by the Board in 1998. In the memorandum accompanying this item, staff recommends that the Board adopt these exemptions in final form.

The regulation contains three other new proposed exemptions. The first exemption relates to the attribution rule of section 23A. The attribution rule states that a transaction by a bank with any person shall be deemed to be a transaction with an affiliate of the bank to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate. Regulation W would exempt from the attribution rule an extension of credit by a bank to a nonaffiliate if the proceeds of the credit extension are used by

¹⁹ See §§ 223.7(c)(4) and 223.16(f) and (h).

the nonaffiliate to purchase products or services from an affiliate of the bank and the extension of credit is made pursuant to a general purpose credit card issued by the bank to the nonaffiliate. In these circumstances, the funding benefit received by the affiliate from the unaffiliated borrower's use of the general purpose credit card is likely to be minimal, and a bank's decision to issue a general purpose credit card (and make loans pursuant to such credit card) to an unaffiliated borrower likely would be based on independent credit standards unrelated to any possible affiliate transaction. Extensions of credit to unaffiliated borrowers pursuant to special purpose credit cards (*i.e.*, credit cards that can only be used or are primarily used to buy goods from an affiliate of the bank), however, would remain subject to the attribution rule.

The second new proposed exemption would exempt from section 23A the purchase by a bank of municipal securities from a securities affiliate of the bank if (i) the securities are rated by a nationally recognized statistical rating organization or represent part of an issue of securities that does not exceed \$25 million; (ii) the securities are eligible for purchase by a state member bank; and (iii) the price of the securities is routinely quoted on an unaffiliated electronic quotation system, the bank obtains two price quotes on the securities or comparable securities from unaffiliated broker-dealers, or the bank purchases the securities during their underwriting at the price indicated in the syndicate manager's written summary of the underwriting. Staff believes that this exemption is appropriate, under the conditions set forth above, because municipal obligations generally have a low default risk. In addition, the exemption is consistent with the expressed desire of Congress to support local communities' use of municipal securities to help meet their financing needs.

The third new exemption would exempt the purchase of an asset from an affiliate by a bank in formation if the appropriate federal banking agency for the bank has approved the asset purchase. Staff believes that the restrictions of section 23A may be unnecessary for these asset purchases because the chartering authority for the new bank reviews the transaction (and, in the case of a bank holding company, the Board also reviews the transaction) to ensure that the transfer does not result in any safety or soundness problems.

CONCLUSION: For the reasons discussed above, staff recommends that the Board authorize issuance of proposed Regulation W and the interim final rules on derivatives and intraday extensions of credit.

Attachments

APPENDIX A

Other Material Provisions of Regulation W

10 and 20 percent quantitative limits:

- Section 23A states that a bank “may engage in a covered transaction with an affiliate only if . . . in the case of any affiliate, the aggregate amount of covered transactions” of the bank will not exceed 10 percent of the capital stock and surplus of the bank. Regulation W would clarify that this limitation prevents a bank from engaging in a new covered transaction with an affiliate if the aggregate amount of covered transactions between the bank and any affiliate (not only the particular affiliate with which the bank proposes to engage in the new covered transaction) would be in excess of 10 percent of the bank’s capital after consummation of the new transaction. (See § 223.2).
- Regulation W, like section 23A, only prohibits a bank from engaging in a new covered transaction if the bank would be in excess of the 10 or 20 percent thresholds after consummation of the new transaction. The regulation does not require a bank to unwind existing covered transactions if the bank exceeds the 10 or 20 percent limits because, for example, its capital declined. (See §§ 223.2 and 223.3).

Collateral requirements:

- Section 23A prohibits a bank from using low-quality assets or securities issued by an affiliate to comply with the collateral requirements of the section. Regulation W adds the following items to the list of ineligible collateral: (i) securities issued by the bank; (ii) intangible assets; and (iii) guarantees and letters of credit. (See § 223.5(c)).
- Regulation W provides that the collateral requirements of section 23A do not apply to the undrawn portion of an extension of credit to an affiliate so long as the bank has no legal obligation to advance additional funds under the credit facility until the affiliate posts the amount of additional collateral required by the statute. This interpretation differs from staff’s previous position on this matter, which required banks that provided a line of credit to an affiliate to secure the full amount of the credit facility throughout the life of the facility. (See § 223.5(g)).

Valuation and timing principles:

- Regulation W provides that if a bank purchases from a third party a loan to an affiliate of the bank, the value of the covered transaction generally is the purchase price paid by the bank for the loan rather than the face amount of the loan. (See § 223.8(a)(2)).
- Regulation W states that a bank shall be deemed to have made an extension of credit under section 23A at the time during the day that the bank becomes legally obligated to make the extension of credit. The regulation thereby makes clear that a loan becomes a covered transaction at the moment the loan agreement is signed, not at the end of the business day on which the loan agreement is signed or at the moment the loan is funded. (See § 223.8(b)(1)).
- Section 23A defines as a covered transaction a bank's acceptance of securities issued by an affiliate as collateral for an extension of credit to any person. Regulation W proposes to value these transactions where the only collateral for the loan is affiliate securities at the lesser of (i) the total amount of the extension of credit and (ii) the fair market value of the affiliate's securities that are pledged as collateral (if such securities are traded in a ready market). This valuation formula represents a relaxation from staff's traditional position, which values these transactions at the total amount of the credit extension. Regulation W proposes to value these transactions where the collateral for the loan includes both affiliate securities and other collateral at the lesser of (i) the total amount of the extension of credit minus the fair market value of the nonaffiliate collateral and (ii) the fair market value of the affiliate's securities that are pledged as collateral (if such securities are traded in a ready market). (See § 223.11).

Financial subsidiaries:

- Regulation W clarifies that any subsidiary of a bank's financial subsidiary will be considered a financial subsidiary of the bank, and thus an affiliate for purposes of section 23A. This prevents a bank from evading the section 23A restrictions on transactions with a financial subsidiary by engaging in transactions with a subsidiary of a financial subsidiary. (See § 223.26(k)(2)).

- The GLB Act provides that the 10 percent quantitative limit of section 23A does not apply with respect to transactions between a bank and any individual financial subsidiary of the bank. Regulation W tracks the statutory language. (See § 223.13(a)).
- The GLB Act provides that a bank's investment in a financial subsidiary of the bank shall not include the retained earnings of the financial subsidiary. Regulation W clarifies that a bank's investment in a financial subsidiary also would not reflect any losses incurred by the financial subsidiary after the bank's investment. (See § 223.13(b)(1)).
- The GLB Act provides that any investment in the securities of a financial subsidiary of a bank by an affiliate of the bank will be treated as an investment in such securities by the bank. The GLB Act also provides that any extension of credit to a financial subsidiary of a bank by an affiliate of the bank will be treated as an extension of credit by the bank to the financial subsidiary if the Board determines that such treatment is appropriate. Regulation W includes both of these provisions and states that any extension of credit to a financial subsidiary of a bank by an affiliate of the bank would be treated as an extension of credit by the bank to the financial subsidiary if the extension of credit is treated as regulatory capital of the financial subsidiary. Staff believes that such treatment is appropriate because if an extension of credit counts as regulatory capital for the financial subsidiary, then the extension of credit by the affiliate is functionally equivalent to an investment in the financial subsidiary, which is treated as a covered transaction under the GLB Act (as described above). (See § 223.13(c)).

Exemptions:

- Section 23A exempts from its quantitative limits and collateral requirements transactions between a bank and any sister "bank" of the bank. Regulation W proposes to restrict the scope of the sister-bank exemption generally to cover transactions between insured banks only. In the absence of such a regulatory restriction, a bank would be able to engage in unlimited transactions with its uninsured depository affiliates and thereby move assets outside of the reach of the FDIC. (See § 223.15(a) and (b)).
- Regulation W would exempt any merger or acquisition transaction between banks that has been approved by the responsible federal banking

agency under the Bank Merger Act. The Board has previously adopted this exemption by interpretation. (See § 223.16(i)).

Section 23B:

- Section 23B prohibits a bank from purchasing a security during the existence of an underwriting syndicate if a principal underwriter of the security is an affiliate of the bank, unless a majority of the directors of the bank approves the purchase based on a determination that the purchase is a sound investment for the bank. Regulation W would allow a bank to satisfy the director approval requirement by having a majority of the bank's directors (i) approve in advance standards for the bank's acquisition of such securities and (ii) monitor such acquisitions on a periodic basis to ensure that they satisfy the standards. This position is consistent with a long-standing staff interpretation of section 23B. (See § 223.20(b)).
- Section 23B states that a bank "may not publish any advertisement or enter into any agreement stating or suggesting that the member bank will in any way be responsible for the obligations of its affiliates." Regulation W clarifies that this provision does not prohibit a bank from issuing a guarantee or letter of credit on behalf of an affiliate, so long as the guarantee or letter of credit complies with section 23A. This position is consistent with a long-standing staff interpretation of section 23B. (See § 223.21).

Definition of Affiliate:

- Section 23A deems the following entities to be an affiliate of a bank: (i) any company, including a REIT, that is "sponsored and advised" by a bank or any affiliate of the bank; and (ii) any investment company registered under the Investment Company Act for which the bank or any affiliate of the bank serves as an investment adviser. Regulation W would expand the definition of affiliate to include any unregistered investment fund if the bank or any affiliate of the bank serves as an investment advisor to the fund and owns more than 5 percent of any class of voting shares of the fund. By doing so, the regulation treats as an affiliate many of the private equity funds, foreign investment funds, and commodity funds that escape treatment as an affiliate because they are not registered under the Investment Company Act. (See § 224(a)(6)). The proposal also would seek comment on whether the subsidiaries of

investment fund affiliates of a bank also should be deemed affiliates of the bank under section 23A.

- The GLB Act creates a rebuttable presumption that a company is an affiliate of a bank if the holding company that controls the bank owns or controls 15 percent or more of the equity capital of the other company under the GLB Act's merchant banking or insurance company investment authority. The proposed regulation includes this presumption and grants three regulatory safe harbors from the presumption (which are consistent with the safe harbors provided in the Board's merchant banking rule): (i) where no representative of the holding company serves as a director of the portfolio company; (ii) where an independent third party owns a greater percentage of the equity capital of the portfolio company than does the holding company, and no more than one representative of the holding company serves as a director of the portfolio company; and (iii) where an independent third party owns more than 50 percent of the voting shares of the portfolio company, and representatives of the holding company do not constitute a majority of the directors of the portfolio company. (See § 223.24(a)(9)).
- Section 23A excludes from the definition of affiliate any subsidiary of a bank (other than a financial subsidiary or a subsidiary bank). Regulation W defines "affiliate" to include any subsidiary of a bank if an affiliate of the bank directly owns or controls more than 25 percent of any class of voting securities of the subsidiary. For example, if a bank owns 50 percent of a company and the bank's holding company (through another chain of ownership) owns the remaining 50 percent of the company, the company will be treated as an affiliate of the bank and not as a subsidiary of the bank. (See § 223.24(b)(1)(iii)).
- Regulation W provides that an employee stock option plan, trust, or similar organization that exists for the benefit of the shareholders, partners, members, or employees of a bank or any affiliate of the bank is generally treated as an affiliate of the bank and not as a subsidiary of the bank. (See § 223.24(b)(1)(iv)).

Other Definitions:

- Regulation W includes two control provisions that are similar to presumptions contained in the Board's Regulation Y (Bank Holding Companies). First, a company will be deemed to control securities,

assets, or other ownership interests controlled by any subsidiary of the company. Second, a company that controls securities (including options and warrants) that are convertible, at the option of the holder or owner, into other securities, will be deemed to control the other securities. (See § 223.26(f)(3) and (4)).

- Section 23A defines low-quality assets to include assets that have been classified in the most recent examination of the affiliate, assets that are in default, and assets that have been renegotiated or compromised. Regulation W would provide that a low-quality asset also includes any:
(i) asset designated by examiners as an “other transfer risk problem”;
(ii) asset classified in any internal classification system used by the bank or the affiliate; and (iii) real estate acquired through foreclosure that has not been reviewed in an examination. (See § 223.26(q)).