October 24, 2002

TO: Board of Governors

FROM: Staff[1]

SUBJECT: Regulation W (implementing sections 23A and 23B of the Federal Reserve Act).

**ACTION REQUESTED:** Approval to issue (i) a final Regulation W (effective April 1, 2003) that comprehensively implements sections 23A and 23B of the Federal Reserve Act and provides several new exemptions that are consistent with the purposes of the statute (Appendix B); (ii) a final rule that rescinds certain existing Board interpretations of sections 23A and 23B, which have been incorporated into Regulation W (Appendix C); and (iii) a proposed rule that seeks public comment on whether to restrict the availability of the 250.250 exemption from section 23A to 100 percent of a bank's capital (Appendix D).

**EXECUTIVE SUMMARY:** Sections 23A and 23B of the Federal Reserve Act impose quantitative and qualitative limits on the ability of a bank to extend credit to, or engage in certain other transactions with, an affiliate. In May 2001, the Board issued (i) a proposed Regulation W to implement comprehensively sections 23A and 23B; and (ii) interim final rules to address under sections 23A and 23B credit exposure arising out of derivative transactions between banks and affiliates and intraday credit extensions by banks to affiliates (as required by the Gramm-Leach-Bliley Act ("GLB Act")).

The Board received approximately 120 comments on the rules. Commenters (including the other Federal banking agencies) endorsed the Board's determination to issue a regulation implementing sections 23A and 23B and consolidating in one

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[1] Legal (Mr. Mattingly, Ms. Nardolilli, and Mr. Van Der Weide); Banking Supervision and Regulation (Mr. Martinson and Ms. Wassom); Research and Statistics (Messrs. Ettin and Parkinson); Federal Reserve Bank of New York (Messrs. Keogh and Schussler and Ms. Virzera).

comprehensive public document 70 years of Board and staff interpretations of the statute. Commenters also expressed support for the Board's decision to include in the regulation a number of new exemptions to ease the compliance burden imposed by the statute. Commenters, however, criticized a number of the specific provisions of proposed Regulation W.

This memorandum discusses in detail nine significant issues raised by commenters on the rules and contains an Appendix A that briefly presents a number of other less material issues regarding Regulation W. This executive summary discusses briefly the six most significant issues raised by commenters. The other three issues discussed in detail in the memorandum are (i) an exemption for loans by a bank to a third party secured by securities issued by a mutual fund affiliate of the bank (an exemption strongly supported by commenters); (ii) an exemption that would permit banking organizations to engage more expeditiously in internal reorganization transactions involving a bank's purchase of assets from an affiliate (subject to a number of conditions, including those that the Board traditionally has imposed when granting case-by-case exemptions for such transactions); and (iii) valuation rules for a bank's investments in, and acquisitions of, affiliates.

1. Derivatives. The draft final rule (i) provides that derivative transactions between banks and their affiliates are subject to the market terms requirement of section 23B and (ii) requires banks to adopt policies and procedures to manage the credit exposure arising from their derivative transactions with affiliates.[2] The final rule also provides that credit derivatives between a bank and a nonaffiliate in

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[2] A bank may engage in transactions subject to the market terms requirement of section 23B only on terms and under circumstances that are at least as favorable to the bank as those prevailing at the time for comparable transactions with unaffiliated companies.

which the bank protects the nonaffiliate from a default on, or decline in value of, an obligation of an affiliate of the bank are covered transactions under section 23A. The final rule does not subject credit exposure arising from bank-affiliate derivatives to the quantitative limits and collateral requirements of section 23A. Nearly all commenters supported this approach to derivatives.

In the near future, staff will present for Board approval a proposed rule that would seek public comment on how to treat under section 23A derivative transactions that are the functional equivalent of a loan by a bank to an affiliate or the functional equivalent of an asset purchase by a bank from an affiliate.

2. Intraday Credit. The draft final rule (i) provides that intraday extensions of credit by a bank to an affiliate are subject to the market terms requirement of section 23B and (ii) exempts intraday credit extensions by a bank to an affiliate from the quantitative limits and collateral requirements of section 23A if the bank adopts policies and procedures to manage the credit exposure arising from its intraday credit extensions to affiliates and has no reason to believe that the affiliate would have difficulty repaying the credit. The vast majority of commenters supported this general approach to intraday credit.

3. Financial Subsidiaries. As required by section 23A, the draft final rule provides that financial subsidiaries of a bank are affiliates of the bank. Thus, under the final rule, transactions between a bank and its financial subsidiary are subject to the requirements of sections 23A and 23B. The final rule, consistent with the statute, defines a financial subsidiary as any subsidiary of a national or state bank that engages in an activity not permissible for national banks to conduct directly.

The final rule, however, exempts insurance agency subsidiaries of national and state banks from the definition of financial subsidiary because these subsidiaries require little funding from their parent bank and do not pose a substantial threat to bank safety and soundness. In addition, the final rule exempts subsidiaries of a state bank that engage only in (i) activities permissible for the state bank to conduct directly (consistent with the Board's long-standing view on operating subsidiaries of banks); or (ii) activities they were lawfully conducting before issuance of the final rule (a grandfather provision for existing subsidiaries).

This approach to financial subsidiaries addresses most of the concerns raised by commenters, other than the Federal Deposit Insurance Corporation ("FDIC"). The FDIC has argued that section 23A only applies to those subsidiaries of state banks specified in section 46 of the Federal Deposit Insurance Act ("FDI Act") (currently, only subsidiaries engaged in underwriting and dealing in corporate securities).[3] As discussed below, staff believes that section 23A provides a definition of financial subsidiary that, by its terms, covers any subsidiary of a bank engaged in an activity not permitted for national banks, and this definition is not limited to those subsidiaries specified in section 46 of the FDI Act.

The FDIC also has argued that the Board should exempt from section 23A transactions between a state bank and subsidiaries approved by the FDIC under section 24 of the FDI Act even if those subsidiaries engage in activities that their parent bank may not conduct directly under Federal or state law. Such an exemption principally would apply to subsidiaries engaged in equity investment or real estate investment and development. The FDIC and other commenters have argued that imposing section 23A on section 24 subsidiaries is unnecessary because the FDIC has imposed regulatory restrictions on transactions between a state bank and its section 24 subsidiaries to protect bank safety and soundness.

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[3] Section 46 of the FDI Act, as added by the GLB Act, provides that subsidiaries of state nonmember banks that engage in activities that national and state member banks may conduct only through a financial subsidiary are subject to many of the same prudential limitations imposed by the GLB Act on financial subsidiaries of national and state member banks.

Moreover, the FDIC has approved only a few hundred section 24 subsidiaries, a large majority of section 24 subsidiaries represent a small part of the capital of their parent banks, and section 24 subsidiaries have not materially affected the safety and soundness of their parent banks.

Staff believes, however, that there are important reasons not to include in the final rule an exemption for section 24 subsidiaries that engage in activities their parent bank may not conduct directly. First, Congress provided a definition of financial subsidiary in section 23A that, by its terms, covers section 24 subsidiaries. Coverage of section 24 subsidiaries that engage in activities not permissible for their parent bank (and, by definition, engage in activities not permissible for national banks) is consistent with an important purpose of the GLB Act -- constraining the ability of a bank to transfer its subsidy to affiliates engaged in activities that the bank cannot conduct directly.

Furthermore, the activities conducted by many section 24 subsidiaries that are not permissible for their parent state banks, including in particular real estate investment and development, increase the risk profile of their parent banks and historically have caused significant losses to the Federal deposit insurance funds. Although section 24 subsidiaries have not to date imperiled their parent banks, banks have been operating in a favorable economic environment since Congress enacted section 24 of the FDI Act. Moreover, the section 24 restrictions imposed by the FDIC are not as comprehensive as those in section 23A and could be removed or relaxed by the FDIC at any time. For these reasons, staff has not included in the draft final rule an exemption for section 24 subsidiaries of a state bank that engage in activities not permitted for their parent bank. As noted above, the final rule does exempt section 24 subsidiaries that are engaged only in activities authorized for their parent bank (which should cover most situations).

The OTS has argued that section 23A's definition of financial subsidiary, which refers to financial subsidiaries of "banks," does not apply to thrifts. Furthermore, Federal law already contains numerous provisions that protect thrifts in their transactions with subsidiaries, including a requirement that thrifts deduct from their capital all investments in a subsidiary engaged in activities that are not permissible for national banks. Based on these considerations and at the request of the OTS, the final rule does not include a provision addressing financial subsidiaries of thrifts.

4. General Purpose Credit Card Exemption. The draft final rule (like the proposed rule) exempts from section 23A extensions of credit by a bank under a general purpose credit card where the borrower uses the credit to purchase goods or services from an affiliate of the bank. The proposed rule defined a general purpose credit card as a credit card issued by a bank that is widely accepted by merchants (such as a Visa card or Mastercard) so long as less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the bank. This definition was criticized by commenters as burdensome.

The draft final rule seeks to address the concerns of commenters by generally exempting from the 25 percent test any bank that does not have nonfinancial affiliates. Banks with retail commercial affiliates typically are the banks whose credit cards are used substantially to purchase goods or services from affiliates. Staff believes that retaining the 25 percent test for banks with nonfinancial affiliates will limit the ability of such banks to use the Federal safety net to subsidize the commercial sales activities of their affiliates and will help protect bank safety and soundness. The final rule also exempts from the 25 percent test any widely accepted credit card offered by a bank that establishes to the Board's satisfaction that a minimal percentage of purchases with the card would be purchases from an affiliate of the bank.

5. Foreign Banks. For competitive equity reasons, the draft final rule (like the proposed rule) applies sections 23A and 23B to transactions between the U.S. branches and agencies of a foreign bank and affiliates of the foreign bank engaged in the United States in several new GLB Act activities: securities underwriting and dealing, insurance underwriting, merchant banking, and insurance company investment. The regulation does not apply sections 23A or 23B to transactions between a U.S. branch or agency and any other type of affiliate (for example, foreign affiliates or U.S. affiliates engaged in pre-GLB Act nonbanking activities), or to transactions between the foreign bank's non-U.S. offices and its U.S. affiliates. This approach is consistent with the Board's previous application of sections 23A and 23B to section 20 affiliates of foreign banks before the GLB Act and securities and merchant banking affiliates of foreign banks after the GLB Act.

A number of commenters, including the Canadian government and the Institute of International Bankers, opposed this aspect of the rule. These commenters contended that the Board lacked legal authority to issue this aspect of the rule and argued that the nonbank affiliates of foreign banks covered by the rule do not have a competitive advantage over the analogous affiliates of U.S. banks.

6. Section 250.250 Exemption. Since 1979, the Board has exempted from section 23A a bank's purchase of loans from an affiliate if (i) the bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes the loan and (ii) the bank commits to purchase the loan prior to the affiliate making the loan (the "250.250 exemption"). The purpose of the exemption was to allow a bank to take advantage of an investment opportunity and not to alleviate the funding needs of an affiliate. By the 1990s, however, some banks were using this exemption to provide nearly all their lending affiliates' funding. In 1995, to ensure that banks used the 250.250 exemption consistently with its original purpose, Board staff opined that the exemption was not available to any bank

whose loan purchases from an affiliate represented more than 50 percent of the loans made by the affiliate.

The proposed rule included staff's 50 percent test and also solicited comment on whether to supplement the bright-line 50 percent test with a requirement that the bank not use the exemption to provide "substantial, ongoing funding" to the affiliate. A few commenters criticized the 50 percent test, and a large number of commenters criticized the "substantial, ongoing funding" test. The draft final rule retains the 50 percent test as a general matter but allows the bank's primary Federal regulator to reduce the 50 percent threshold prospectively, on a case-by-case basis, if appropriate to protect the safety and soundness of the bank.

The proposed rule also invited comment on whether to limit the amount of assets that a bank may purchase from an affiliate under the 250.250 exemption to some percentage of the bank's total assets. Many commenters objected to this proposed condition. In light of the adverse comment and the lack of specificity on this limit in proposed Regulation W, staff seeks Board approval to issue a proposed rule (concurrently with final Regulation W) that would invite public comment on whether to deny the 250.250 exemption to any bank if assets purchased by the bank from an affiliate under the 250.250 exemption represent more than 100 percent of the bank's capital. Staff believes that such a limit would help prevent a compromise of the bank's underwriting processes and would help cap the bank's risk of loss from these transactions.

**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.[4] Congress originally enacted section 23A as part of

[4] 12 U.S.C. §§ 371c and 371c-1.

the Banking Act of 1933, and it initially applied only to member banks. 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 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 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.

<u>Overview of Section 23A</u>

Section 23A is simple in concept, but complicated in its application -- particularly to large, complex banking organizations participating in modern financial markets. Section 23A seeks to achieve its goals in several ways. First, it prohibits a bank from initiating a "covered transaction" with an affiliate if, after the transaction, (i) the aggregate amount of the bank's covered transactions with <u>that</u> 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 <u>all</u> 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. Third, section 23A prohibits a bank from purchasing low-quality assets from its affiliates. Fourth, the statute requires that a bank's extensions of credit to affiliates be secured by a statutorily defined amount of collateral. Finally, the statute contains an attribution rule that provides that any transaction by a bank with any person is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate.

Overview of Section 23B

Section 23B protects a bank by requiring that transactions between the bank and its affiliates occur on market terms. Section 23B applies this restriction to any covered transaction (as defined in section 23A) with an affiliate as well as certain other transactions, including (i) any sale of assets by the bank to an affiliate; (ii) any payment of money or furnishing of services by the bank to an affiliate; (iii) any transaction in which an affiliate acts as an agent or broker for the bank or for any other person if the bank is a participant in the transaction; and (iv) any transaction by the bank with a third party if an affiliate has a financial interest in the third party or if an affiliate is a participant in the transaction.

Proposed Regulation W and Interim Rules on Derivatives and Intraday Credit

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. Historically, the Board has provided this guidance through a series of Board interpretations and staff opinions.

On May 11, 2001, the Board issued a proposed Regulation W to implement comprehensively sections 23A and 23B. The Board decided to issue such a proposed rule for several reasons. First, the new regulatory framework established by the GLB Act emphasized the importance of sections 23A and 23B as a means to protect banks from losses in connection with the newly authorized affiliates.

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 statute and would help ensure that the statute is consistently interpreted and applied by the Federal banking agencies and the industry.

Finally, issuing a proposed regulation allowed the public an opportunity to comment on Board and staff interpretations of sections 23A and 23B, many of which were adopted many years ago or without the benefit of a public comment process.

Among other things, the GLB Act required the Board to adopt final rules, by May 12, 2001, to address under section 23A credit exposure by a bank to its affiliates on derivative transactions and intraday credit extensions. The Board issued interim final rules to fulfill this statutory mandate on May 11, 2001 (concurrently with proposed Regulation W). The interim final rules became effective January 1, 2002. The Board also sought public comment as part of the Regulation W rulemaking process on how these types of transactions should be treated under section 23A.

Public Comments

The comment period on proposed Regulation W expired on August 15, 2001, and the Board received approximately 100 public comments and 7 comments from Reserve Banks on the proposed rule. The Board also received 21 comments on the Board's interim final rules on derivative transactions and intraday extensions of credit. Commenters included 3 Members of Congress, 75 banking organizations, 20 trade associations representing the banking or financial services industry, 5 state banking departments or other governmental agencies, 9 law firms or individuals, and several other organizations.

Nearly all the commenters generally supported the Board's decision to issue Regulation W and the interim rules but opposed or raised concerns about one or more aspects of the regulations. Staff has prepared summaries of the public comments and Reserve Bank comments on Regulation W and the interim rules, and the summaries are available for your review in the Office of the Secretary.

Final Regulation W

Staff carefully reviewed and analyzed the issues raised by commenters in the process of producing a draft final Regulation W, which is attached hereto as Appendix B.[5] In July 2002, staff circulated a previous draft of the final rule to the other Federal banking agencies for their review. The current draft of the final rule addresses most of the principal concerns raised by the agencies.

In connection with its preparation of draft final Regulation W, staff reviewed the existing Board and staff interpretations of section 23A contained in the Code of Federal Regulations ("CFR") and the Federal Reserve Regulatory Service ("FRRS"). If the Board adopts final Regulation W, staff recommends that the Board rescind the other Board interpretations of section 23A contained in the CFR because they would be superseded by the final rule. A draft rule that would rescind these existing Board interpretations is attached hereto as Appendix C. If the Board adopts final Regulation W, staff also intends to delete most of the FRRS

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[5] The draft final Regulation W in Appendix B uses bold text to indicate those portions of the rule that are interpretive gloss on the statutory provisions.

summaries of the other Board and staff interpretations of section 23A because they are outdated or would be superseded by the final rule.[6]

In order to comply with Federal laws relating to the effective dates of new regulations, the effective date of final Regulation W would be April 1, 2003. Staff also recommends that the Board provide banks with a limited transition period and a limited grandfather authority for transactions consummated on or before the date of publication of the final rule in the Federal Register.[7] The Federal Register documents accompanying the final rule would contain these provisions.

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

**DISCUSSION:** Regulation W addresses a variety of issues raised by the GLB Act and by long-standing provisions of sections 23A and 23B. This section of the memorandum discusses the following nine significant issues raised by the public comments on the regulation:

- derivative transactions between banks and their affiliates;
- intraday credit extensions by banks to their affiliates;

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[6] As discussed below in section 7 of this memorandum, staff also has produced a draft proposed rule that would seek further comment on restricting the availability of the 250.250 exemption from section 23A. This proposed rule and accompanying Federal Register notice are attached hereto as Appendix D.

[7] Staff believes that the final rule should give banks until July 1, 2003, to bring into compliance with the final rule any transaction that was consummated on or before the publication of the final rule in the Federal Register. In addition, staff believes that the final rule should permanently grandfather any asset purchase by a bank from an affiliate that (i) was consummated on or before the publication of the final rule in the Federal Register and (ii) qualified for an exemption from section 23A at the time of its consummation but would not qualify for an exemption under the final rule.

- definition of financial subsidiary;
- an exemption for general purpose credit cards;
- valuation of a bank's investments in, and acquisitions of, affiliates;
- application of sections 23A and 23B to the U.S. branches and agencies of foreign banks;
- section 250.250 exemption (which permits a bank to purchase loans from an affiliate);
- an exemption for internal corporate reorganizations; and
- an exemption for loans to third parties secured by affiliated mutual fund shares.

1. Derivative Transactions

a. Background

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.

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 ("BHC") 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.

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.

b. Actions already taken by the Board

As noted above, the GLB Act required the Board to adopt, by May 12, 2001, a final rule to address as covered transactions under section 23A the credit exposure arising from derivative transactions between banks and their affiliates.[8] Determining the appropriate treatment for derivative transactions under section 23A is a complex and important endeavor. In light of the complexities of the subject matter and the statutory deadline in the GLB Act, the Board took the following two steps on May 11, 2001, to address the credit exposure arising from bank-affiliate derivative transactions under section 23A.

First, the Board published an interim final rule (concurrently with proposed Regulation W) that subjected bank-affiliate derivative transactions to the market terms requirement of section 23B. Accordingly, the interim rule required each bank to:

- have in place credit limits on its derivatives exposure to affiliates that are at least as strict as the credit limits the bank imposes on unaffiliated

[8] At the time of enactment of the GLB Act, the Board had not ruled on whether derivative transactions between a bank and an affiliate were covered transactions under section 23A or subject to the market terms requirement of section 23B. Although industry practice generally treated bank-affiliate derivative transactions as subject to section 23B, industry practice did not treat bank-affiliate derivative transactions as subject to section 23A.

companies that are engaged in similar businesses and are substantially equivalent in size and credit quality;

- 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; and
- 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 interim rule also required, under section 23A, 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 final rule had a delayed effective date of January 1, 2002.

The second step that the Board took to address credit exposure on bank-affiliate derivative transactions under section 23A was to ask for public comment in the Federal Register notice accompanying proposed Regulation W on a set of questions regarding the appropriate treatment of these transactions under section 23A, including whether to subject the transactions to the quantitative limits and collateral requirements of section 23A. The Federal Register notice made clear that the Board would not take additional steps to address bank-affiliate derivatives without seeking further public comment on a concrete proposal.

c. Public comments

About 16 commenters wrote in support of the interim rule approach to derivatives. One commenter, however, argued that the interim rule was ineffective and insufficiently detailed to satisfy the GLB Act requirement that the Board issue a final rule addressing derivatives as covered transactions. Another commenter objected to the interim rule on a different ground, arguing that, as long as a BHC manages derivatives credit risk effectively, each subsidiary bank of the BHC should not be required to have separate policies and procedures on derivatives.

Commenters uniformly argued against subjecting bank-affiliate derivative transactions to the quantitative limits and collateral requirements of section 23A. The principal arguments advanced by commenters were that derivatives do not fit within any of the five categories of covered transaction in section 23A; section 23B and the well-developed risk management practices in the institutional derivatives market are sufficient protection to banks; derivatives generally are not entered into for funding purposes; and covering derivatives under section 23A would be burdensome and may reduce the ability of a banking organization to centralize its risk management in the unit(s) best able to bear the risk.

d. Staff recommendations

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 believes that more time is needed to determine whether the general approach of the interim rule on bank-affiliate derivatives will suffice to prevent banks from incurring problematic levels of credit exposure to affiliates in these transactions.

Federal Reserve examiners recently conducted a limited survey of a number of large banking organizations to ascertain their compliance with the Board's interim rule on derivatives.[9] The survey suggested that reliance on the somewhat subjective standards of section 23B to regulate bank-affiliate derivatives introduces some compliance risk; the survey also indicated that active supervision of bank-affiliate derivatives, at least at the limited number of banks that have a material volume of these transactions, can successfully resolve section 23B compliance problems and should be continued. In order to enhance supervision of bank-affiliate derivatives, the preamble to final Regulation W would state that the Board views market terms for derivatives among major financial institutions as requiring daily marks to market and two-way collateralization above a relatively small exposure threshold.

Staff recommends that the Board take two additional regulatory steps at this time to address bank-affiliate derivatives.

i. Cover derivatives that are the functional equivalent of a guarantee

First, the Board should incorporate into Regulation W the Board's previously expressed view that credit derivative transactions between a bank and a nonaffiliate in which the bank protects the nonaffiliate from a default on, or decline in value of, an obligation of an affiliate of the bank are covered transactions under section 23A. In the preamble to proposed Regulation W, the Board stated that such derivative transactions are guarantees by a bank on behalf of an affiliate (and, hence, covered transactions) under section 23A.

A number of commenters discussed the appropriate treatment under section 23A of these derivative transactions. Three commenters supported treating these derivatives as a guarantee on behalf of an affiliate under section 23A. Three other commenters argued that the Board should not treat these derivatives as

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[9] Federal Reserve examiners also surveyed these same banking organizations to assess their compliance with the Board's interim rule on intraday credit. The results of this survey are discussed below in section 2 of this memorandum.

section 23A guarantees if the bank has hedged its exposure to the affiliate with a third party. Two commenters expressed the view that the rule should not treat these derivatives as section 23A guarantees if the affiliate's obligations represent a small portion of the reference assets for the credit derivative.

The final Regulation W provides that these credit derivatives are covered transactions under section 23A and gives several examples of this type of derivative transaction.[10] Consistent with the Board's traditional views on hedging under section 23A, the rule does not allow a bank to reduce its covered transaction amount for these derivative transactions to reflect hedging positions established by the bank with third parties. In addition, staff does not agree with commenters that an exception to the rule should be created for a credit derivative in which affiliate obligations represent a small portion of the reference assets underlying the credit derivative. Staff intends to interpret this provision of the rule, however, so as to treat such a credit derivative as a covered transaction only to the extent that the derivative provides credit protection with respect to obligations of an affiliate of the bank.

ii. <u>Include the interim rule in Regulation W</u>

Second, in order to consolidate all the Board's views on sections 23A and 23B into one place, the Board should incorporate the provisions of the separate interim final rule on derivatives into Regulation W.

e. <u>Future actions</u>

In the near future, staff will present for the Board's approval a draft proposed rule that would invite public comment on how to treat as covered transactions under section 23A certain derivative transactions that are the

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[10] In most instances, the covered transaction amount for such a credit derivative would be the notional amount of the derivative.

functional equivalent of a loan by a bank to an affiliate or the functional equivalent of an asset purchase by a bank from an affiliate. An example of a loan-equivalent derivative would be the purchase of a deep-in-the-money option by a bank from an affiliate. An example of an asset-purchase-equivalent derivative would be a credit default swap under which a bank agreed to compensate an affiliate for any default of a loan asset held by the affiliate.

2. <u>Intraday Extensions of Credit</u>

The GLB Act also required 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.[11] The Board took a two-step approach, similar to the Board's approach to bank-affiliate derivative transactions, to fulfill this statutory mandate. First, the Board published an interim final rule on May 11, 2001, 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. The interim final rule had a delayed effective date of January 1, 2002.

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[11] The text of section 23A does not indicate that a transaction must extend overnight to qualify as an extension of credit. Nevertheless, at the time of enactment of the GLB Act, the Board had not ruled on whether intraday credit extensions by a bank to an affiliate were covered transactions under section 23A or subject to the market terms requirement of section 23B. Industry practice did not treat an intraday credit extension as subject to section 23A or 23B.

Second, the Board requested comment on a more detailed and more restrictive proposed rule on intraday credit extensions by banks to affiliates in Regulation W. Proposed Regulation W treated all intraday credit extensions as covered transactions but exempted those intraday credits that arose in connection with the performance by a bank, in the ordinary course of business, of securities clearing and settlement transactions or payment transactions on behalf of an affiliate. The more limited Regulation W exemption for intraday credit was available only if the bank (i) had no reason to believe that the affiliate would have difficulty repaying the extension of credit; (ii) established limits on the net amount of intraday credit that the bank may extend to affiliates; and (iii) maintained policies and procedures for monitoring each affiliate's compliance with the limits. Under the Regulation W proposal, intraday extensions of credit by a bank to an affiliate that did not meet these conditions were subject to the quantitative, collateral, and other requirements of section 23A. Importantly, under the proposed rule, an intentional intraday loan by a bank to an affiliate outside of the clearing context (for example, a loan to allow the affiliate to meet a debt obligation coming due during the day) would become fully subject to section 23A at the time during the day that the bank made the loan.

Most commenters on the intraday credit issue expressed support for either the interim rule or proposed Regulation W approach to intraday credit, although the interim rule approach garnered more support. Three commenters rejected both approaches, however, and urged the Board to treat intraday credit as not subject to section 23A. Although no commenter directly criticized the interim rule approach, a number of commenters criticized or suggested improvements to the proposed Regulation W approach.

Eight commenters advocated abandoning the Regulation W approach to intraday credit because, among other things, (i) banks do not use intraday credit to fund affiliates; (ii) intraday credit becomes covered by section 23A at the end of the day and, therefore, banks have incentives to monitor intraday overdrafts by affiliates; (iii) banks do not have the systems to monitor intraday credit transactions with all accounts of all affiliates in real time, and the cost of developing and maintaining such global systems solely to comply with Regulation W would outweigh any risk management benefit; and (iv) banks have not suffered losses on intraday credit extensions to affiliates. According to these commenters, the minimal benefits of the Regulation W approach would not outweigh the substantial costs.

Many commenters (including the Office of the Comptroller of the Currency ("OCC") and the Office of Thrift Supervision ("OTS")) urged the Board to provide an exemption for intraday credit arising from special purpose credit card transactions if the Board were to decide to treat intraday credit extensions as covered transactions under section 23A. These commenters explained that special purpose credit card banks make thousands of credit extensions each day that are deemed to be credit extensions to affiliates under section 23A's attribution rule. These banks currently comply with section 23A by either selling their credit card receivables at the end of each day or fully securing them at the end of each day with segregated, earmarked deposit accounts. According to commenters, the proposed Regulation W approach to intraday credit would significantly disrupt existing practices for special purpose credit card banks and would create substantial inefficiencies for these banks (requiring thousands of sales of receivables each day instead of one sale at the end of each day). These commenters emphasized that third-party customers, not the affiliated merchants, are liable for repayment to the bank on these transactions, and that the intraday risk to the bank on these transactions is similar to the risk on payment or settlement transactions.

In staff's view, existing business practices indicate that the potential risk reduction benefits afforded by full application of the requirements of section 23A to intraday credit exposures would not justify the costs to banking organizations of implementing these requirements at this time. Intraday overdrafts and other forms of intraday credit extensions generally are 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 is 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 would require banks to not only measure exposures across multiple accounts, offices, and systems on a global basis but also 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. Furthermore, there is no evidence that banks, including special purpose credit card banks, have suffered losses from intraday extensions of credit to affiliates.

Staff has reviewed the policies and procedures that a number of large banks adopted to comply with the Board's interim final rule on intraday credit to affiliates. This review confirmed that requiring banks to adopt policies and procedures for managing the credit exposure arising from intraday credit extensions to affiliates and subjecting such transactions to section 23B is the most workable solution for addressing intraday credit exposure of banks to affiliates. For the most part, surveyed banking organizations treated intraday credit to affiliates in the same manner as they treated intraday credit to third parties.

In light of these considerations, staff recommends that the Board adopt an approach to intraday credit that is a combination of the approaches contained in the interim rule and proposed Regulation W. Final Regulation W would provide that intraday credit extensions by a bank to an affiliate are section 23A covered transactions but would exempt all intraday credit extensions from the quantitative and collateral requirements of section 23A if the bank (i) adopts policies and procedures for the management of intraday credit exposure, as required by the interim rule; and (ii) has no reason to believe that any affiliate receiving intraday credit would have difficulty repaying the credit in accordance with its terms.

The approach of the final rule should impose substantially less burden on banks than would the proposed Regulation W approach. Most significantly, whereas the proposed rule exempted only intraday credit extensions relating to clearing and settlement, the final rule exempts all types of intraday credit, including intraday credit granted pursuant to a credit card. In light of the limited scope for, and limited history of, abuse of intraday credit to affiliates and the significant burden of verifying and documenting the use of each intraday credit extension to an affiliate, staff does not believe that the regulatory benefits of this aspect of the proposed rule outweigh its regulatory burden. The global exemptive approach of the final rule (unlike the proposed rule) also should avoid interrupting the existing, unproblematic intraday business practices of banks that issue special purpose credit cards. In addition, the approach of the final rule imposes more discipline on banks than would the interim rule approach in that the final rule requires a bank to make intraday assessments of the credit quality of each affiliated borrower and restricts a bank's intraday credit extensions to an affiliate if the bank has any doubt as to the affiliate's ability to repay the credit.

3. Financial Subsidiaries

Congress amended section 23A in 1982 to provide that subsidiaries of a bank are not affiliates of the bank under the statute. Congress adopted this approach on the premise that subsidiaries of a bank generally are consolidated with the bank and engage only in those activities that the bank itself could engage in directly, and hence that such a subsidiary was more like a department of the bank than a separate company. In order to prevent evasions of section 23A, the 1982 amendments gave the Board explicit authority to treat as an affiliate of a bank any subsidiary if the relationship between the bank and the subsidiary could affect transactions between the companies to the detriment of the bank.

In 1997, in light of the expanding powers of subsidiaries of banks, the Board relied on this statutory authority to issue for comment a proposal to extend section 23A to transactions between a bank and a subsidiary of the bank engaged in activities not permissible for the bank to engage in directly. The Board took no final action on this proposal in light of Congressional consideration of financial modernization legislation. In 1999, the GLB Act authorized banks to own "financial subsidiaries" that engage in activities not permissible for the parent bank to conduct directly, such as underwriting and dealing in bank-ineligible securities. The GLB Act also amended section 23A to define a financial subsidiary of a bank to be an affiliate of the bank and, thus, subjected transactions between the bank and a financial subsidiary to the limitations of sections 23A and 23B.

Section 23A, as amended by the GLB Act, defines a financial subsidiary as a subsidiary of <u>any</u> bank (state or national) that is engaged in an activity that is not permissible for <u>national</u> banks (other than a subsidiary that Federal law specifically authorizes national banks to control).[12] Proposed Regulation W defined financial subsidiary by repeating the definition of the term in section 23A. The proposed rule also noted that many state banks have authority to engage directly in activities that would not be permissible for national banks and sought comment on how to apply the section 23A definition of financial subsidiary to state banks. In addition, the proposal requested comment on the appropriateness of exempting from the definition of financial subsidiary any subsidiary of a bank that engages solely in agency activities.

a. Subsidiaries of state banks

Commenters offered a wide variety of alternative ways for the Board to apply the statute's definition of financial subsidiary to state banks. One set of commenters (including the Conference of State Bank Supervisors and the American Bankers Association) asked the Board to define a financial subsidiary of a state bank to include only those subsidiaries that are engaged in activities that the parent state bank could not engage in directly. Another set of commenters (including the FDIC) argued that the Board should define a financial subsidiary of a state bank to include only those subsidiaries subject to section 46 of the FDI Act; that is, those subsidiaries that are engaged in principal activities that may only be

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[12] Specifically, section 23A defines a "financial subsidiary" as "any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States." Section 5136A, in turn, defines a financial subsidiary as any company that is controlled by one or more insured depository institutions other than (i) a subsidiary that engages solely in activities that national banks are permitted to engage in directly or (ii) a subsidiary that national banks are specifically authorized to control by the express terms of a Federal statute (other than section 5136A), such as an Edge Act corporation or a SBIC. 12 U.S.C. § 24a(g)(3). Section 5136A also generally prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities. 12 U.S.C. § 24a(a)(2).

conducted by a national bank through a financial subsidiary (currently, only subsidiaries engaged in underwriting and dealing in bank-ineligible securities). Many other commenters advocated for a complete exemption for all subsidiaries of a state bank. Over 30 commenters -- the largest number of commenters on any issue raised by the proposed rule -- urged the Board to define financial subsidiary to exclude those subsidiaries of state banks that are engaged in grandfathered securities investment activities under section 24(f) of the FDI Act.[13]

Staff believes that the literal terms of section 23A provide that a subsidiary of a state bank that engages in an activity that is not permissible for national banks to conduct directly is a financial subsidiary of the state bank (unless Federal law specifically authorizes national banks to control such a subsidiary, such as an Edge Act subsidiary). This conclusion holds regardless of whether the activity (i) is permissible for the state bank to conduct directly; (ii) is an agency or principal activity; (iii) was approved by the FDIC under section 24 of the FDI Act; or (iv) was conducted by the subsidiary prior to the enactment of the GLB Act.

Staff recommends that the final rule define financial subsidiary in this manner but also contain exemptions for two classes of subsidiaries of state banks. First, the final rule would exempt any subsidiary of a state bank that engages in activities permissible for the parent state bank to conduct directly. In staff's view, if a state bank has authority under state and Federal law to conduct an activity directly in the bank, section 23A normally should not apply to transactions between the bank and a subsidiary engaged in the activity. In such circumstances, the bank could conduct the activity directly in the bank and fund the activity free of

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[13] 12 U.S.C. § 1831a(f). Section 24(f) of the FDI Act permits state banks that had lawfully made certain liquid equity investments in 1990-91 to continue to engage in such equity investment activities so long as such equity investments do not exceed an amount equal to the bank's capital.

section 23A. Staff is aware of no material supervisory reason to create a disincentive for the bank to conduct such a bank-permissible activity through a subsidiary if the bank has determined -- for tax, liability, or other reasons -- that the activity is most safely and efficiently conducted through a subsidiary. This approach is consistent with the spirit of the GLB Act and with the Board's 1997 rulemaking on subsidiaries of banks.

Second, the final rule would exempt any subsidiary of a state bank that would be considered a financial subsidiary solely by reason of activities that the subsidiary was legally conducting prior to issuance of final Regulation W. Among other things, this exemption would remove from the definition of financial subsidiary those subsidiaries of state banks that are engaged in the limited, grandfathered securities investment activities authorized under section 24(f) of the FDI Act. Staff does not believe that this exemption would apply to a significant number of other material subsidiaries of state banks. The exemption would be appropriate, however, so as not to impose a hardship on the existing business operations and structures of state banks.[14]

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[14] Neither of these exemptions for subsidiaries of state banks would be available for any subsidiary of a state bank that engages in principal activities that the GLB Act requires a national bank to conduct in a financial subsidiary, such as underwriting and dealing in bank-ineligible securities. Section 46 of the FDI Act explicitly provides that such subsidiaries of a state bank are to be treated as section 23A affiliates of the bank. 12 U.S.C. § 1831w. As noted above, the FDIC agrees that such subsidiaries should be section 23A affiliates.

The GLB Act authorizes the Board and the Treasury Department to determine jointly, on or after November 12, 2004, that financial subsidiaries may engage in merchant banking activities. GLB Act § 122. If the Board and Treasury were to make such a determination, the merchant banking subsidiaries of banks would be section 23A financial subsidiaries under the final rule's approach.

As noted above, the FDIC argued that the only section 23A financial subsidiaries of state banks are those subsidiaries that are subject to section 46 of the FDI Act. Staff does not believe that this argument is convincing. Although section 46 of the FDI Act specifically notes that sections 23A and 23B apply to transactions between a state bank and a section 46 subsidiary, section 46 does not change the definition of financial subsidiary contained in section 23A or, by its terms, limit the coverage of sections 23A and 23B to only section 46 subsidiaries.

The FDIC and other commenters also argued that the Board should exempt any subsidiary of a state bank (other than a section 46 subsidiary) approved by the FDIC under section 24 of the FDI Act even if the subsidiary engages in activities that the parent bank may not conduct directly. Section 24 of the FDI Act prevents a subsidiary of an insured state bank from engaging in any principal activity that is not permissible for a subsidiary of a national bank unless (i) the FDIC has made a determination that the activity would pose no significant risk to the Federal deposit insurance funds; and (ii) the state bank remains in compliance with the capital guidelines of its appropriate Federal banking agency.[15] The principal effect of granting this exemption would be to exempt from section 23A transactions between a state bank and its section 24 subsidiaries engaged in equity investment (which Federal law prohibits insured state banks from engaging in)[16] or real estate investment and development (in those states that do not permit state banks to conduct these activities directly).

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[15] 12 U.S.C. § 1831a(d).

[16] Federal law generally prohibits insured state banks from making equity investments of a type or in an amount that is not permissible for national banks. See 12 U.S.C. 1831a(c) and (f).

Commenters argued that additional considerations support granting an exemption for section 24 subsidiaries. First, commenters contended that section 24 of the FDI Act and the FDIC's regulations thereunder establish a reasonably comprehensive system for protecting insured state banks that engage, or propose to engage, in principal activities not permissible for national banks. In this regard, the FDIC's section 24 regulations impose restrictions on transactions between a state bank and many types of section 24 subsidiaries (including subsidiaries engaged in real estate investment and development).[17] In addition, the FDIC has approved only a few hundred section 24 subsidiaries since Congress added section 24 to the FDI Act in 1991, and the FDIC has received very few requests under section 24 in the past couple of years. Finally, a large majority of section 24 subsidiaries represent a small part of the capital of their parent state banks, and section 24 subsidiaries have not to date materially affected the safety and soundness of state banks.

Staff believes that there are important reasons, however, not to include in the final rule an exemption for section 24 subsidiaries that engage in activities their parent bank may not conduct directly. First, Congress provided a definition of financial subsidiary in section 23A that, by its terms, covers section 24 subsidiaries.[18] In addition, coverage of section 24 subsidiaries that engage in

[17] See 12 CFR 362.4(b)(5) and (d).

[18] Some commenters also argued that section 24 subsidiaries engaged in real estate investment and development or equity investment are not section 23A financial subsidiaries because (i) section 23A defines a financial subsidiary as a subsidiary that "would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes" and (ii) section 5136A prohibits financial subsidiaries of national banks from engaging in real estate investment and development and merchant banking. Staff finds this argument unpersuasive. Although section 5136A prohibits financial subsidiaries of national banks from engaging in real estate investment and development or equity investment, a subsidiary engaged in such

activities not permissible for their parent bank (and, by definition, activities not permissible for national banks) is consistent with an important purpose of the GLB Act -- constraining the ability of a bank to transfer the subsidy arising from the bank's access to the Federal safety net to affiliates engaged in activities that the bank cannot conduct directly.

Furthermore, the activities conducted by many section 24 subsidiaries that are not permissible for their parent state bank, including in particular real estate investment and development, increase the risk profile of their parent bank and historically have caused significant losses to the Federal deposit insurance funds.[19] Although section 24 subsidiaries have not to date imperiled their parent banks, banks have been operating in a favorable economic environment since Congress enacted section 24 of the FDI Act. Moreover, the section 24 restrictions imposed by the FDIC are not as comprehensive as those in section 23A[20] and could be

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activities would meet the terms of the financial subsidiary definition in section 23A and section 5136A.

[19] As noted above, Congress expressed specific concern in the GLB Act about real estate investment and development activities by prohibiting the financial subsidiaries of national banks from engaging in these activities. 12 U.S.C. § 24a(a)(2). It is also worth noting that, because the final rule includes an exemption for subsidiaries of a state bank engaged in activities that the parent state bank could engage in directly, the principal beneficiaries of a separate exemption for section 24 subsidiaries would be subsidiaries of a state bank engaged in activities that state or Federal law has determined are too risky to be conducted directly in the bank.

[20] The FDIC's restrictions, among other things, do <u>not</u> (i) include a 10 percent quantitative limit on covered transactions between the bank and any single section 24 subsidiary; (ii) restrict the ability of a bank to finance a third party's purchase of assets from a section 24 subsidiary of the bank; or (iii) treat a purchase of assets from a section 24 subsidiary or the issuance of a guarantee or letter of credit on behalf of a section 24 subsidiary as covered transactions.

removed or relaxed by the FDIC at any time.[21] Furthermore, although the Board could revoke any exemption granted to section 24 subsidiaries if the exemption were to have adverse safety and soundness consequences, such a future revocation may be difficult to effect because it would come at a time when state banks are least able to comply with the requirements of section 23A. For these reasons, staff has not included in the draft final rule an exemption for section 24 subsidiaries of a state bank that engage in activities their parent bank may not conduct directly.

b. Agency subsidiaries of national banks and state banks

Section 23A's definition of financial subsidiary does not exclude subsidiaries of banks that are engaged solely in agency activities.[22] As a result, insurance agency subsidiaries of national banks that operate outside a town of 5,000, for example, are financial subsidiaries of their parent banks under the statute.

A large number of commenters urged the Board to exclude subsidiaries engaged in agency activities from the definition of financial subsidiary. Staff

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[21] The FDIC has required state banks to deduct from tier 1 capital the full amount of their equity investments in most section 24 subsidiaries (including real estate investment and development subsidiaries). Consistent with the interagency capital rule on nonfinancial equity investments adopted on January 25, 2002, however, the FDIC now only requires that state banks deduct from tier 1 capital between 8 percent and 25 percent of an equity investment in most section 24 subsidiaries. See 12 CFR Part 325, Appendix A, § II.B.6.ii. The FDIC retains authority under the nonfinancial equity investment capital rule to apply a higher capital charge on these investments, but the FDIC has not chosen to do so at this time.

[22] The FDIC argued that agency subsidiaries of state banks cannot be financial subsidiaries under section 23A because (i) the only section 23A financial subsidiaries of state banks are those subsidiaries that qualify as financial subsidiaries under section 46 of the FDI Act and (ii) agency subsidiaries cannot qualify as financial subsidiaries under section 46. For the reasons discussed above, staff does not believe that this argument is convincing.

recommends that the Board exempt from the definition of financial subsidiary any subsidiary of a national bank or state bank that would be considered a financial subsidiary solely because the subsidiary engages in insurance agency activities that are not permissible for the parent bank. The Federal banking agencies have had significant experience in supervising insurance agency subsidiaries of banks, and such subsidiaries do not pose the kind of threat to the safety and soundness of banks that section 23A was designed to prevent. In addition, because insurance agency subsidiaries are not capital-intensive, they require little funding from the parent bank and, hence, stand to benefit less from the subsidy implicit in the Federal safety net than would a subsidiary engaged in activities as principal. Under the draft final rule, therefore, subsidiaries of banks engaged in insurance agency activities or agency activities permissible for the bank to engage in directly would not be section 23A financial subsidiaries.

Staff does not believe that it is appropriate at this time to grant an exemption for all subsidiaries engaged exclusively in agency activities because defining what constitutes an agency activity is problematic, and some agency activities involve significant risk. In the unusual circumstance where a subsidiary of a bank conducts a non-insurance agency activity that is not permissible for the bank to conduct directly, the bank may request that the Board grant a specific exemption for the subsidiary.

c. Subsidiaries of thrifts

Although section 23A applies by its terms only to "member banks," the Home Owners' Loan Act ("HOLA") subjects every thrift to section 23A "in the same manner and to the same extent as if the [thrift] were a member bank."[23] As noted above, section 23A defines a financial subsidiary as "any company that is a

[23] 12 U.S.C. § 1468(a).

subsidiary of a bank that would be a financial subsidiary of a national bank." Because all "member banks" under section 23A are also "banks" under section 23A, and because HOLA subjects every thrift to section 23A as if the thrift were a "member bank," one could read the financial subsidiary definition in section 23A as covering any subsidiary of a thrift that would be a financial subsidiary of a national bank.

On the other hand, the OTS argued that thrifts generally are not "banks" under section 23A and, hence, that thrifts do not have financial subsidiaries under section 23A. The OTS also pointed out that, although the GLB Act contains explicit and detailed provisions (unrelated to section 23A) regarding financial subsidiaries of national banks and state banks, the GLB Act does not contain any explicit reference to financial subsidiaries of thrifts. In addition, HOLA already contains numerous provisions that protect thrifts in their transactions with subsidiaries. For example, HOLA requires thrifts to deduct from their capital all investments in, and extensions of credit to, any subsidiary engaged in activities that are not permissible for national banks.[24] HOLA also prohibits a thrift from investing more than 3 percent of its assets in service corporation subsidiaries.[25] Staff notes that there is little empirical evidence to date that subsidiaries of thrifts have had a material adverse effect on the safety or soundness of their parent thrifts since becoming subject to heightened Federal regulation in 1989.

Given the protections contained in HOLA, the draft of Regulation W circulated by staff to the other Federal banking agencies this July included exemptions from the definition of financial subsidiary for subsidiaries of thrifts. The OTS requested that the Board delete these exemptions from the final rule and

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[24] 12 U.S.C. § 1464(t)(5); 12 CFR 559.3(j)(2) and part 567.

[25] 12 U.S.C. § 1464(c)(4)(B).

allow the OTS to determine which, if any, subsidiaries of thrifts are financial subsidiaries. In light of all these considerations, staff recommends that the final rule not address financial subsidiaries of thrifts at this time.

4. General Purpose Credit Card Exemption

a. Proposed rule and public comments

Section 23A's 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. The attribution rule, by its terms, would cover an extension of credit by a bank to an individual who uses the proceeds to purchase a product or service from an affiliate of the bank. Proposed Regulation W exempted from the attribution rule an extension of credit by a bank to a nonaffiliate pursuant to a general purpose credit card in such a situation. The proposed rule defined a general purpose credit card as a credit card issued by a bank that is widely accepted by merchants that are not affiliates of the bank (such as a Visa card or Mastercard) if less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the bank. Under the proposed rule, extensions of credit to unaffiliated borrowers pursuant to special purpose credit cards (that is, credit cards that may only be used or are substantially used to buy goods from an affiliate of the bank) would remain subject to the attribution rule.[26]

The Board proposed this exemption because the funding benefit received by the affiliate from the use of general purpose credit cards by unaffiliated borrowers is likely to be minimal, and a bank's decision to issue a general purpose credit card (and make loans pursuant to such a credit card) to an unaffiliated borrower likely

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[26] As noted above, most special purpose credit card banks comply with section 23A by selling their receivables or establishing a segregated, earmarked deposit account to collateralize their receivables at the end of each day.

would be based on independent credit standards unrelated to any possible affiliate transaction.

Commenters strongly supported inclusion of an exemption for extensions of credit to nonaffiliates pursuant to a general purpose credit card, but 25 commenters (including the OCC, FDIC, and OTS) criticized the rule's definition of general purpose credit card.[27] These commenters contended that the 25 percent limit in the definition of general purpose credit card would be burdensome for banks in terms of monitoring and recordkeeping. Some of these commenters also alleged that the limit is not needed for safety and soundness given that the card must be widely accepted by merchants and given the virtual impossibility of a bank using general purpose credit card transactions to assist a troubled affiliate. These commenters argued that the possibility that customers may use credit card credit to buy goods from a nonaffiliate should ensure that credit is granted on market terms, and pointed out that general purpose credit card transactions expose the bank to the credit risk of thousands or millions of individual unaffiliated credit card customers and do not expose the bank to the credit risk of the affiliate.

Several commenters made suggestions about how the Board should modify, or clarify the application of, the quantitative limit in the definition of general purpose credit card. A couple of commenters believed that the rule should raise the 25 percent limit to 50 percent. In addition, several commenters asked the Board to provide banks with a cure period if they fail to meet the test and requested that the Board provide guidance as to whether banks must do continuous or only periodic compliance checks with the quantitative limit.

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[27] Many commenters urged the Board to expand the exemption for general purpose credit cards to cover other forms of general revolving consumer debt, including home equity lines of credit, overdraft lines on checking accounts, and margin loans.

b. Staff recommendations

Staff continues to believe that the definition of general purpose credit card should include the 25 percent limit. If more than 25 percent of the purchases effected through a credit card are purchases of products and services from affiliates of the card-issuing bank, the bank has significant incentives to relax its credit underwriting standards to facilitate the sale of goods and services by its affiliates. Staff believes that a limit should be placed on the ability of a bank to use the Federal safety net to subsidize the financing of the sales activities of affiliates of the bank.

Staff recommends, however, that the final rule contain several adjustments to ease the compliance burden on card-issuing banks. First, the final rule would provide several different methods for a bank to demonstrate that its credit card meets the 25 percent test:

- For a bank that has no commercial affiliates (other than those authorized by section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if the bank has no reason to believe that it would fail the test. Such a bank would not be obligated to establish systems to compute strict compliance with the 25 percent test.
- For a bank that has commercial affiliates (beyond those authorized by section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if:
    - ➢ the bank establishes systems to compute compliance with the 25 percent test on an ongoing basis and periodically validates its compliance with the test; or
    - ➢ the bank presents information to the Board demonstrating that its card should always comply with the 25 percent test.

The draft final rule adopts a stricter compliance standard for banks with commercial affiliates because banks with retail commercial affiliates typically are the banks whose credit cards are used substantially to purchase goods or services from affiliates. Staff also believes that the stricter standard for banks with commercial affiliates will help constrain the mixing of banking and commerce by limiting the ability of such banks to subsidize the commercial activities of their affiliates.

Second, the final rule would give banks that fall out of compliance with the 25 percent test a three-month grace period to return to compliance before extensions of credit under the card become covered transactions. Third, the final rule would provide banks that are required to validate their ongoing compliance with the 25 percent test a fixed method, time frames, and examples for computing compliance.

Staff does not expect that banks whose cards fail to meet the terms of the general purpose credit card exemption would be compelled to discontinue the cards. Many credit card banks issue special purpose credit cards. Most of these banks historically have complied with section 23A by selling their credit card receivables to an affiliate at the end of each day.[28] Under such arrangements, which also should be permissible under final Regulation W, the bank does not provide continuous financing for its commercial affiliates; rather it obtains funding from outside sources on a daily basis for its affiliate-related credits. Banks that issue VISA cards and Mastercards that fail to satisfy the 25 percent test likely would use the same mechanisms to comply with section 23A as do banks that currently issue special purpose credit cards.

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[28] As discussed above, the Board has not historically treated intraday credit extensions as covered transactions under section 23A. The final Regulation W would provide a fairly comprehensive exemption for intraday extensions of credit.

5. Valuation of a Bank's Investments in, and Acquisitions of, Affiliates

Proposed Regulation W provided 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 generated significant 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 operating subsidiary of the bank after the transaction. The rules for valuing these two types of transaction are different because the company in which the bank invests remains an affiliate of the bank after the first described transaction, whereas the company in which the bank invests becomes an operating subsidiary of the bank (and no longer an affiliate of the bank) after the second described transaction. As discussed below, section 23A treats transactions between a bank and its operating subsidiary differently than transactions between a bank and its affiliate.

a. Valuing an investment in securities issued by an affiliate

Section 23A includes as a covered transaction a bank's purchase of, or investment in, securities issued by an affiliate. Proposed Regulation W required 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.[29] 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

[29] Staff traditionally has advised banks to value a purchase of securities issued by an affiliate at the purchase price paid by the bank for the securities.

bank's carrying value for the securities.[30] In addition, under the rule, if the bank's carrying value of the affiliate securities increases or decreases 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.

A number of commenters objected to this valuation formula and offered alternatives. Several commenters argued that investments in an affiliate's securities should be valued at the lower of purchase price and carrying value. Under this formula, a contribution of affiliate securities to a bank would be valued at zero, and the bank would be permitted without limit to reduce the covered transaction amount for a purchase of affiliate securities as the value of the securities declined. These commenters justified their formula's treatment of bank investments in a declining affiliate by pointing out that a bank's capital must be reduced to reflect the decline in value of the affiliate's securities and by noting that their approach more accurately reflects the bank's actual remaining financial exposure to the affiliate.

Under the commenters' formula, a bank's section 23A value for an investment in affiliate securities also would not increase as the value of the securities increased. These commenters argued that an increase in the value of an investment does not create additional risk of loss for the investor and that there is no justification for restricting section 23A lending as an affiliate increases in financial strength. One of these commenters contended that the regulation's valuation rule is inconsistent in increasing the section 23A value of an investment

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

as the affiliate prospers but not decreasing the section 23A value of the investment as the affiliate becomes troubled.

Other commenters argued that investments in an affiliate's securities always should be valued at the purchase price or, at a minimum, that a contribution of affiliate securities initially should be valued at zero.

Staff recommends that the Board adopt the valuation rule contained in the proposed regulation. Staff continues to believe that several important considerations support the carrying value approach of the valuation rule. First, the approach is 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 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 the approach. 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, the carrying value approach is consistent with the purposes of section 23A -- limiting the financial exposure of banks to their affiliates and promoting safety and soundness. The rule would require a bank to revalue upwards the amount of an investment in affiliate securities only when the bank's exposure to 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 valuation rule also provides that the covered transaction amount of a bank's investment in affiliate securities can be no less than the purchase price paid by the bank for the securities, even if the carrying value of the securities declines below that amount. Although this aspect of the valuation rule is not consistent with GAAP, using the bank's purchase price for the securities as a floor for valuing the covered transaction is appropriate for several reasons. First, it ensures that the amount of the covered transaction never falls below the amount of funds actually transferred by the bank to the affiliate in connection with the investment. In addition, the purchase price floor 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. As the affiliate declined, the bank's carrying value of the affiliate's securities would decline, the section 23A value of the bank's investment likely would decline, and, consequently, the bank would be able to provide additional funding to the affiliate under section 23A. This type of increasing support for an affiliate in distress is precisely what section 23A was intended to restrict.

b. Valuing the contribution of an affiliate to a bank

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

Although the Board often 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 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.[31]

Proposed Regulation W, however, required a bank to value this type of contribution transaction based on the total amount of liabilities owed by the contributed affiliate to any person. In effect, the rule required 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.

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[31] The Board adopted this view of these internal reorganization transactions principally because the transactions often were motivated by funding problems at the transferred affiliate or the bank's parent holding company 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.

A number of commenters objected to this approach. Many of them complained that the approach would prevent banking organizations from efficiently reorganizing their operations and would put BHCs at a competitive disadvantage with other companies that can more easily restructure themselves. These commenters also protested that the approach ignores the substantial protection received by the bank from the corporate limited liability shield of the contributed company.

Some of these commenters simply asserted that the rule should not treat a donation of shares as a "purchase" of assets because the bank is obtaining an asset (shares) at no cost. Other commenters offered a variety of alternative formulas for valuing these transactions. Some of the principal alternatives offered were to value these covered transactions at (i) the purchase price paid by the bank for the shares plus any liabilities of the transferred company minus the value of the assets of the transferred company (perhaps as verified by an independent third party); (ii) the purchase price paid by the bank for the shares; (iii) the GAAP net worth of the transferred company; or (iv) the purchase price paid by the bank for the shares plus any liabilities owed by the transferred company to affiliates of the bank (staff's traditional approach).

For the following reasons, staff recommends that the Board adopt a valuation formula for these transactions that is substantially identical to the formula set forth in the proposed rule. Regulation W's proposed treatment of these transactions 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 operating subsidiaries as a single unit. Transactions between a bank and its operating subsidiary are not treated as covered transactions between a bank and an affiliate under section 23A; rather, they are treated as transactions entirely inside the bank.[32]

Because a bank and its operating subsidiaries are treated as a single unit under section 23A, viewing a transaction in which an affiliate becomes an operating subsidiary of the bank as a purchase of all the affiliate's assets and an assumption of all the affiliate's liabilities by the bank is consistent with the structure of section 23A. The validity of this approach is reinforced by the fact that, after the transaction, the bank could merge the newly acquired subsidiary directly into itself (and thus directly assume the company's liabilities) outside the scope of section 23A.

The Regulation W approach also is 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.

The potential burden of this approach on banking organizations 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 operating subsidiary of the bank after the transfer. The Board typically has approved such exemptions so long as the transaction appears to be consistent with safety and soundness, the entity transferring the affiliate to the bank makes appropriate asset quality assurances to the Board, and the bank's appropriate

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

Federal banking agency and the FDIC express 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. Moreover, as discussed below in section 8 of this memorandum, the draft final Regulation W includes a regulatory exemption for certain internal corporate reorganizations that do not exceed 25 percent of the bank's capital stock and surplus.

6. Foreign Banks

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 or agency 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.

In order to ensure competitive equity, 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").[33]

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[33] 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 CFR 225.200.

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.[34]

Proposed and final Regulation W would 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 newly authorized financial activities under the GLB Act:

- non-credit-related insurance underwriting;
- full-scope securities underwriting and dealing;
- merchant banking;[35] and
- insurance company investment activities.

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 (for example, 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. In addition, the regulation would permit U.S. branches and

[34] See 12 CFR 225.176(b)(6).

[35] 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 that the proceeds of the covered transaction are used for the purpose of funding the affiliate's merchant banking activities.

agencies of a foreign bank to compute their section 23A "capital stock and surplus" by reference to the capital of the foreign bank.[36]

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 should 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 activities that a U.S. bank cannot engage in directly or through an operating subsidiary. A U.S. bank may affiliate itself with a company engaged in the 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. 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 BHCs before the passage of the GLB Act (other than section 20 affiliates). Staff recognizes the hardship these requirements

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[36] This position is generally consistent with the approach taken by the Board in the section 20 Operating Standards and in the merchant banking rule.

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 operating subsidiary) and, hence, may be funded by a U.S. 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 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, applying sections 23A and 23B should help ensure competitive equity between foreign banks and U.S. banking organizations in the funding of certain of their U.S. nonbank operations.

Eight commenters strenuously objected to the foreign bank provisions of the proposed rule, including the Canadian Department of Finance, the Institute of International Bankers, the Canadian Bankers Association, and the Swiss Bankers Association. Several of these commenters challenged the Board's authority under section 114 of the GLB Act to apply section 23A to the U.S. branches and agencies of foreign banks. According to these commenters, the Board's action fails to meet the first requirement of section 114 (consistency with Federal banking law) because Federal banking law does not generally subject U.S. branches and agencies of foreign banks to section 23A. In commenters' view, the Board's action also fails to meet the second prong of section 114 (intention to prevent adverse effects) because the Board has not presented specific evidence of actual abuse and is admittedly acting to fight possible future abuse.

Staff believes that a partial application of sections 23A and 23B to the U.S. branches and agencies of foreign banks is consistent with Federal banking law.

Staff is aware of, and commenters have cited, no Federal banking laws that contradict or otherwise conflict with the foreign bank provisions of Regulation W. Moreover, staff disagrees with the implication of commenters' views of section 114, which would prevent the Board from imposing safeguards under the section unless such safeguards were already present in Federal banking law. Commenters also have failed to present evidence to support their claim that the Board may only use section 114 to combat adverse effects for which the Board has made specific findings. Nothing in the text or legislative history of the GLB Act supports this position. Staff does not believe that section 114 requires the Board to wait, observe, and document damage to financial institutions or markets before it may take action under section 114 to impose prudential safeguards.

Several commenters on the foreign bank provisions of the proposed rule advanced the proposition that foreign banks do not enjoy a subsidy in the United States and do not have a competitive advantage over U.S. banks. In fact, according to these commenters, U.S. banks have a competitive "home field" advantage in the United States. The Board's partial extension of sections 23A and 23B to cover U.S. branches and agencies of foreign banks does not depend for its justification on whether foreign banks operating in the United States <u>generally</u> have a competitive advantage over U.S. banks. Rather, as noted above, the rule would extend the scope of sections 23A and 23B to address a specific potential competitive imbalance: the funding advantages enjoyed by the indicated types of affiliates of foreign banks as compared to the same types of affiliates of U.S. banks. Foreign banks are able to raise low-cost deposits abroad and to use this funding to finance, including through their U.S. branches and agencies, the activities of the indicated U.S. affiliates without having to comply with sections 23A and 23B. U.S. banks are limited by sections 23A and 23B in the extent to which they are able to finance the operations of the indicated affiliates.

7. Section 250.250 Exemption

In 1979, the Board issued a formal interpretation of section 23A (codified at 12 CFR 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 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 alleviate the working capital needs of an affiliate.

By 1995, some BHCs 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. 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.[37] Staff reasoned that, in these circumstances, the asset purchases looked less like the bank taking advantage of an investment opportunity brought to it by the affiliate and more like the bank providing the principal 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.

The proposed rule included staff's 50 percent test as a condition to the availability of the 250.250 exemption and also solicited comment on whether to

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

supplement the bright-line 50 percent test with a requirement that the bank not use the 250.250 exemption to provide "substantial, ongoing funding" to the affiliate.

a. The traditional 50 percent test

Several commenters explicitly supported the Board's retention of a 50 percent limit on the amount of loans a bank may purchase from an affiliate under the 250.250 exemption. Six commenters requested that the Board remove the 50 percent test because, in the view of these commenters, it is unnecessary and burdensome and most of these bank-affiliate arrangements are designed to benefit the bank. Two commenters asked the Board to modify the 50 percent test. One of these commenters stated that, if the rule retains the 50 percent limit, the limit should be revised to be 50 percent of the entire assets of the affiliate (not just the credit portfolio of the affiliate). The other commenter asked that the 50 percent per affiliate limit be revised to be 50 percent of the loan portfolio of all lending affiliates in the aggregate (to reduce the burden of monitoring each affiliate's compliance with the 50 percent test).

Staff recommends that the Board adopt the 50 percent test. Staff continues to believe that if a bank purchases more than half of the extensions of credit originated by an affiliate, the purchases represent the principal ongoing funding mechanism for the affiliate. The bank's status as the predominant source of financing for the affiliate calls into question the availability of alternative funding sources for the affiliate, places significant pressure on the bank to continue to support the affiliate through asset purchases, and reduces the bank's ability to make independent credit decisions with respect to the asset purchases. The final rule does not expand the denominator of the 50 percent test to include all the assets of the affiliate or all the lending portfolios of all the lending affiliates of the bank. In staff's view, the bank's underwriting integrity may be compromised if any single affiliate becomes dependent on the bank for financing, even if that single affiliate is a diversified company that becomes dependent on the bank for financing of only one portion of its business.

b. The "substantial, ongoing funding" test

One commenter supported the rule's inclusion of the "substantial, ongoing funding" test. Seventeen commenters (including most of the banking industry trade associations) -- nearly three times as many commenters as criticized the traditional 50 percent test -- urged the Board to remove the "substantial, ongoing funding" test. These commenters contended that the test is too vague and subjective, it may disrupt many existing operations, it would prevent banks and their affiliates from accomplishing rational business planning, and there is no evidence that the existing 50 percent test has failed to check abuse.

A "substantial, ongoing funding" test would provide examiners with the 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. On the other hand, such a subjective standard would create legal uncertainty for banks that purchase a substantial amount of assets from their lending affiliates. In addition, use of a "substantial, ongoing funding" standard could result in inconsistent application of the 250.250 exemption by the different Federal banking agencies and by different examiners within a banking agency.

Staff does not believe that the final rule should include such a supplemental standard in the 250.250 exemption. Staff recommends, however, that the final rule allow the appropriate Federal banking agency for a bank to reduce the 50 percent threshold prospectively, on a case-by-case basis, in those situations where the agency believes that the bank's asset purchases from an affiliate under the exemption pose a safety and soundness threat to the bank. Although this agency discretion to tighten the 50 percent threshold may result in some inconsistency in application of the exemption, the supervisory benefits of the flexibility should outweigh its potential adverse effects.

c. Test based on size of bank

The proposed rule also sought 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. Ten commenters objected to placing a limit on the percentage of a bank's assets that represent assets purchased from an affiliate under the 250.250 exemption. These commenters argued that case-by-case review is a better approach to addressing situations where a large portion of a bank's assets are loans purchased from an affiliate. These commenters believed that the remaining conditions of the exemption should suffice to prevent abuse of the bank. One commenter, on the other hand, recommended that the rule include a 50 percent limit based on the assets of the bank.

Staff recommends that the Board issue, concurrently with final Regulation W, a proposed rule (attached hereto as Appendix D) that would seek public comment on whether to deny the 250.250 exemption to any bank if assets purchased by the bank from an affiliate under the 250.250 exemption represent more than 100 percent of the bank's capital stock and surplus. In circumstances where a bank acquires a substantial percentage of its assets through the 250.250 exemption, a bank's credit underwriting process may be compromised as a result of the bank's substantial dependence on the affiliate for asset growth. Prohibiting a bank from using the 250.250 exemption to accumulate assets representing more than 100 percent of the bank's capital would help prevent such compromises and help cap the bank's risk of loss from 250.250 transactions.

The Board has reviewed several cases in the past few years where a nonbanking company proposed to charter or acquire a bank for the principal purpose of purchasing loans or leases from the nonbanking company. In one of these cases, the Board conditioned its approval of the company's BHC formation application on the bank not using the 250.250 exemption to acquire more than 50 percent of its credit portfolio (or such lower percentage as may be established by the Board in Regulation W). Staff supported a tentative 50 percent of credit portfolio threshold in that particular case, rather than a lower threshold, for two reasons. First, the applicant agreed to lower the percentage of the bank's assets acquired through the 250.250 exemption if required by the terms of final Regulation W. Second, the Board had an opportunity in advance to examine carefully the business plan and underwriting standards of the bank and determined that a 50 percent threshold was appropriate in light of the facts of that particular case. Staff does not consider a 50 percent of credit portfolio threshold to be sufficient as a generally applicable regulatory condition going forward.

Staff believes that it would be appropriate to issue a separate proposed rule on this topic (rather than incorporating a limit based on the size of the bank into final Regulation W's version of the 250.250 exemption) because of the substantial adverse comment received on this topic, the fact that proposed Regulation W did not set forth a specific numerical threshold for comment, and because the Board in a previous case used a higher threshold than what staff believes is appropriate as a regulatory threshold.

8. <u>Internal Corporate Reorganization Exemption</u>

In the preamble to the proposed rule, the Board noted that it has granted numerous section 23A exemptions, on a case-by-case basis, for transactions involving the transfer (by merger, purchase and assumption transaction, or otherwise) by a holding company of one of its nonbank subsidiaries to a subsidiary bank. The preamble also noted that 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 shares to the bank must provide certain assurances concerning the quality of the assets being transferred, (iii) the disinterested directors of the bank must approve the transaction in advance, (iv) the transfer must not include any low-quality assets, and (v) the bank's appropriate Federal banking agency and the FDIC must inform the Board that they have no objection to the transaction.

Several commenters requested that the Board include such an exemption in the final rule. Staff recommends that the Board provide a regulatory exemption for certain internal corporate reorganization transactions. Under this exemption, a bank would be permitted to purchase assets (other than low-quality assets) from an affiliate (including in connection with an affiliate share transfer that the rule treats as a purchase of assets) if the following set of conditions is met.

First, the asset purchase must be part of an internal corporate reorganization of a holding company that involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate. Stated another way, the asset purchase cannot be part of a series of periodic, ordinary course asset transfers from an affiliate to a bank. Second, the bank's holding company must provide the Board with contemporaneous notice of the transaction and must commit to the Board to make the bank whole, for a period of two years, for any transferred assets that become low-quality assets. Third, a majority of the bank's directors must review and approve the transaction prior to consummation. Fourth, the section 23A value of the covered transaction must be less than 10 percent of the bank's capital stock and surplus (or up to 25 percent of the bank's capital stock and surplus with the prior approval of the bank's appropriate Federal banking agency). Fifth, the bank's holding company and all its subsidiary depository institutions must be well capitalized and well managed and must remain well capitalized upon consummation of the transaction.

Although these criteria are stricter than what the Board traditionally has applied in connection with its case-by-case exemptions for asset purchases, the heightened strictness is appropriate in exchange for the flexibility that the regulatory exemption grants banks. Although the regulatory exemption would eliminate the Board's opportunity to block certain corporate reorganizations of a banking organization based on an ad hoc analysis of the condition of the bank or the nature or quality of the assets being transferred to the bank, staff believes that the well-capitalized and well-managed requirements, the two-year buyback commitment, and the quantitative limit in the rule should prevent banking organizations from abusing their banking units in reorganization transactions.

9. Exemption for Loans Secured by Affiliated Mutual Fund Shares

Section 23A defines as a covered transaction a bank's acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company. In connection with the proposed rule, the Board specifically sought comment on whether to exempt from section 23A loans to third parties secured by affiliate-issued mutual fund shares. A substantial number of commenters advocated granting this exemption and offered the following principal arguments in support of their position: (i) the bank is not funding an affiliate in these transactions; (ii) although section 23A includes as a covered transaction a loan to a third party collateralized by affiliate securities, the purpose of including this covered transaction was to prevent evasion, and evasion is implausible when the collateral taken by the bank is affiliate-issued mutual funds; (iii) tracking these loans can be very burdensome as many of the loans are small and the value of the mutual fund collateral changes daily; (iv) the assets of an affiliated mutual fund generally are shares of nonaffiliates, which could otherwise serve as collateral for the loan without creating a covered transaction under section 23A; and (v) mutual funds are highly regulated, their shares are highly liquid and can only be purchased at their daily net asset value, and mutual funds are required by law to have boards of directors that are largely independent of the bank and its affiliates.

In the proposal, the Board asked for comment on five potential conditions to the availability of this exemption: (i) the borrower does not use the proceeds of the loan to purchase shares of the affiliated mutual fund; (ii) the borrower is not an executive officer of the bank or its affiliates; (iii) the price of the mutual fund shares is quoted routinely in a widely disseminated news source; (iv) the shares of the mutual fund are widely held by the public; and (v) the bank and its affiliates do not own in the aggregate more than 5 percent of the shares of the mutual fund. Although a few commenters recommended that the Board drop all five of these conditions, most commenters on this aspect of the proposal raised specific objections to particular conditions.

For many of the reasons advanced by commenters, staff recommends that the final rule include an exemption for extensions of credit by a bank that are secured by shares of an affiliated mutual fund. Staff further recommends, however, that the exemption be subject to the following conditions in order to protect bank safety and soundness.

First, to ensure that the affiliate collateral is liquid and trades at a fair price, the affiliated mutual fund must be an open-end investment company that is registered with the SEC under the Investment Company Act of 1940. Second, to ensure that the bank can easily establish and monitor the value of the affiliate collateral, the mutual fund shares serving as collateral for the extension of credit must have a publicly available market price. Third, to reduce the bank's incentives to use these extensions of credit as a mechanism to support the affiliated mutual fund, the bank and its affiliates must not own more than 5 percent of the fund's shares (excluding certain shares held in a fiduciary capacity). Finally, the proceeds of the extension of credit must not be used to purchase the mutual fund shares serving as collateral or otherwise used to benefit an affiliate.[38]

**CONCLUSION:** For the reasons discussed above, staff recommends that the Board authorize issuance of final Regulation W, the final rule to rescind the existing Board interpretations of sections 23A and 23B in 12 CFR part 250, and the proposed rule on the 250.250 exemption from section 23A. Staff also requests the authority to make minor and technical changes to the attached rule documents prior to publication. If the Board approves issuance of final Regulation W, staff will distribute the Federal Register preamble to the rule (which represents the Board's detailed, public explanation of the terms of the rule) for notation vote shortly.

Attachments

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38 In such circumstances, the bank's extension of credit would be covered by the literal terms and spirit of section 23A's attribution rule. 12 U.S.C. § 371c(a)(2).

# APPENDIX A

## Other Material Provisions of Regulation W

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 of 1940 for which the bank or any affiliate of the bank serves as an investment advisor. Regulation W expands 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 of 1940. (See § 223.2(a)(6)).

- 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 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 § 223.2(a)(9)).

- Final Regulation W (unlike the proposed rule) provides, consistent with existing staff interpretations, that any subsidiary of an affiliate of a bank is also an affiliate of the bank (See § 223.2(a)(11)).

- Section 23A authorizes the Board to determine that any company that has certain relationships with a bank or an affiliate of the bank is an affiliate of the bank. Final Regulation W (unlike the proposed rule) provides that these determinations may be made by the Board or by the appropriate Federal banking agency for the relevant depository institution (acting under authority delegated by the Board). (See § 223.2(a)(12)).

- Section 23A excludes from the definition of affiliate any subsidiary of a bank (other than a financial subsidiary or a subsidiary depository institution). Regulation W defines "affiliate" to include any subsidiary of a bank if affiliates or controlling shareholders of the bank also control the subsidiary outside the chain of control running through the bank. 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 § 223.2(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 § 223.2(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 instruments (including options and warrants) that are convertible, at the option of the holder, into other securities, will be deemed to control the other securities. (See § 223.2(g)(3) and (4)).

- Final Regulation W (unlike the proposed rule) also contains a rebuttable presumption that a company will be deemed to control another company if the first company owns or controls more than 25 percent of the total equity of the second company. (See § 223.2(g)(5)). This control presumption is not contained in Regulation Y, but has been consistently applied by Board staff in making control determinations under the BHC Act and section 23A.

- The proposal sought comment as to whether the Board should treat cross-affiliate netting arrangements as covered transactions under section 23A. Cross-affiliate netting arrangements are arrangements among a bank, one or more affiliates of the bank, and one or more nonaffiliates of the bank, where (i) a nonaffiliate is permitted to deduct obligations of an affiliate of the bank to the nonaffiliate when settling the nonaffiliate's obligations to the bank; or (ii) a bank is required or permitted to add the obligations of an affiliate of the bank to a nonaffiliate when determining the bank's obligations to the nonaffiliate. Final Regulation W provides that such arrangements are covered transactions under section 23A. (See § 223.2(h)(5)).

- 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 asset (i) designated by examiners as an "other transfer risk problem"; (ii) classified in any internal classification system used by the bank or the affiliate; or (iii) acquired in satisfaction of a debt previously contracted that has not been reviewed in an examination. (See § 223.2(u)).

- Proposed Regulation W did not define "obligations of, or fully guaranteed as to principal and interest by, the United States or its agencies." The final rule defines this term by cross-reference to the Board's Regulation A, which identifies the principal classes of U.S. government obligations that are eligible to serve as collateral for Federal Reserve advances to member banks. The Regulation A list includes Fannie Mae and Freddie Mac debt securities. This position is consistent with a long-standing staff interpretation of section 23A. (See § 223.2(y)).

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. Proposed Regulation W clarified 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. Many commenters objected to this interpretation of the 10 percent limit. Final Regulation W takes these comments and provides that the 10 percent limit only prevents a bank from engaging in a new covered transaction with an affiliate if the aggregate amount of covered transactions between the bank and such affiliate would be in excess of 10 percent of the bank's capital. (See § 223.11).

- 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 §§ 223.11 and 223.12).

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) equity securities issued by the bank and debt securities issued by the bank that constitute regulatory capital of the bank; (ii) intangible assets; and (iii) guarantees and letters of credit. (See § 223.14(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 § 223.14(f)(2)).

- Section 23A provides that a loan by a bank to an affiliate must meet the collateral requirements of the statute, but does not explicitly provide that a bank's investment in the debt securities of an affiliate must meet the collateral requirements. Regulation W provides that a bank's investment in the debt securities (including commercial paper) of an affiliate is subject to the collateral requirements of section 23A unless the bank purchases the affiliate's debt securities from a nonaffiliate in a bona fide secondary market transaction. (See §§ 223.2(o)(4) and 223.14(f)(3)).

Valuation and Timing Principles:

- Regulation W provides that if a bank purchases from a nonaffiliate 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 § 223.21(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, <u>not</u> at the end of the business day on which the loan agreement is signed or at the moment the loan is funded. (<u>See</u> § 223.21(b)(1)).

- Regulation W provides that if a bank purchases from an affiliate an extension of credit to a third party, the value of the covered transaction generally is the purchase price paid plus any additional amount that the bank could be required to provide to the borrower under the credit arrangement. (<u>See</u> § 223.22(a)(2)(iv)).

- 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 values these transactions where the <u>only</u> 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 values 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). (<u>See</u> § 223.24).

<u>Financial Subsidiaries</u>:

- 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. (<u>See</u> § 223.32(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 contains this provision and 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. (<u>See</u> § 223.32(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 § 223.32(c)).

Exemptions:

- Section 23A exempts from its quantitative limits and collateral requirements transactions between a bank and any sister "bank" of the bank. Proposed Regulation W restricted 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. Several commenters objected to this aspect of the proposed rule and questioned the Board's authority to curtail a statutory exemption. Staff believes that the proposed regulatory restriction of the sister-bank exemption is consistent with safety and soundness and within the Board's authority to issue regulations under section 23A to carry out the purposes of, and prevent evasion of, the section. Accordingly, the final rule contains the restriction. (See § 223.41(a) and (b)).

- Section 23A fully exempts any extension of credit by a bank to an affiliate that is fully secured by U.S. government obligations or a segregated, earmarked deposit account with the bank. Final Regulation W (unlike the proposed rule) provides that an extension of credit by a bank to an affiliate that is partially secured by such types of collateral is exempt to the extent of the value of such collateral. (See § 223.42(c)).

- Proposed Regulation W exempted any merger or acquisition transaction between a bank and an affiliated depository institution that has been approved by the responsible Federal banking agency under the Bank Merger Act. The Board previously had adopted this exemption by interpretation. The final rule contains this exemption and (unlike the proposed rule) also exempts any merger or acquisition transaction between a bank and the U.S. branch or agency of an affiliated foreign bank that has been approved under the Bank Merger Act. (See § 223.42(j)).

- Final Regulation W (unlike the proposed rule) provides an exemption for the purchase of securities by a bank from its securities affiliate if the bank or the affiliate is acting exclusively in a riskless principal capacity. (See § 223.42(m)).

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 allows 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 § 223.53(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 § 223.54).

APPENDIX B

Draft Final Regulation W

For the reasons set out in the preamble, title 12 of the Code of Federal Regulations is amended by adding a new part 223 to read as follows:

## PART 223–TRANSACTIONS BETWEEN MEMBER BANKS AND THEIR AFFILIATES (REGULATION W)

223.61 How do sections 23A and 23B apply to U.S. branches and agencies of foreign banks?

**Subpart H–Miscellaneous Interpretations**

223.71 How do sections 23A and 23B apply to transactions in which a member bank purchases from one affiliate an asset relating to another affiliate?

Authority: 12 U.S.C. 371c(b)(1)(E), (b)(2)(A), and (f), 371c-1(e), 1828(j), and 1468(a).

**Subpart A–Introduction and Definitions**

**§ 223.1 Authority, purpose, and scope.**

(a) Authority. The Board of Governors of the Federal Reserve System (Board) has issued this part (Regulation W) under the authority of sections 23A(f) and 23B(e) of the Federal Reserve Act (12 U.S.C. 371c(f), 371c-1(e)).

(b) Purpose. Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c-1) establish certain quantitative limits and other prudential requirements for loans, purchases of assets, and certain other transactions between a member bank and its affiliates. This regulation implements sections 23A and 23B by defining terms used in the statute, explaining the statute's requirements, and exempting certain transactions.

(c) Scope. Sections 23A and 23B and this regulation apply by their terms to "member banks" – that is, any national bank, State bank, trust company, or other institution that is a member of the Federal Reserve System. In addition, the Federal Deposit Insurance Act (12 U.S.C. 1828(j)) applies sections 23A and 23B to insured State nonmember banks in the same manner and to the same extent as if they were member banks. The Home Owners' Loan Act (12 U.S.C. 1468(a)) also applies sections 23A and 23B to insured savings associations in the same manner and to the same extent as if they were member banks (and imposes two additional restrictions).

**§ 223.2 What is an "affiliate" for purposes of sections 23A and 23B and this regulation?**

(a) For purposes of this part and except as provided in paragraphs (b) and (c) of this section, "affiliate" with respect to a member bank means:

(1) Parent companies. Any company that controls the member bank;

(2) Companies under common control by a parent company. Any company**, including any subsidiary of the member bank,** that is controlled by a company that controls the member bank;

(3) Companies under other common control. Any company**, including any subsidiary of the member bank,** that is controlled, directly or indirectly, by trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the member bank;

(4) Companies with interlocking directorates. Any company in which a majority of its directors, trustees, **or general partners** (or individuals exercising similar functions) constitute a majority of the persons holding any such office with the member bank or any company that controls the member bank;

(5) Sponsored and advised companies. Any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the member bank or an affiliate of the member bank;

(6) Investment companies.

(i) Any investment company for which the member bank or any affiliate of the member bank serves as an investment adviser, as defined in section 2(a)(20) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(20)); and

**(ii) Any other investment fund for which the member bank or any affiliate of the member bank serves as an investment advisor, if the member**

**bank and its affiliates own or control in the aggregate more than 5 percent of any class of voting securities or of the equity capital of the fund;**

(7) **Depository institution** subsidiaries. A **depository institution** that is a subsidiary of the member bank;

(8) Financial subsidiaries. A financial subsidiary of the member bank;

**(9) Companies held under merchant banking or insurance company investment authority.**

**(i) In general. Any company in which a holding company of the member bank owns or controls, directly or indirectly, or acting through one or more other persons, 15 percent or more of the equity capital pursuant to section 4(k)(4)(H) or (I) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H) or (I)).**

**(ii) General exemption. A company will not be an affiliate under paragraph (a)(9)(i) of this section if:**

**(A) The holding company presents information to the Board that demonstrates, to the Board's satisfaction, that the holding company does not control the company; and**

**(B) The company is not otherwise an affiliate under this section.**

**(iii) Specific exemptions. A company also will not be an affiliate under paragraph (a)(9)(i) of this section if:**

**(A) (1) No director, officer, or employee of the holding company serves as a director, trustee, or general partner (or individual exercising similar functions) of the company;**

**(2) A person that is not affiliated or associated with the holding company owns or controls a greater percentage of the equity capital of the company than is owned or controlled by the holding company, and no more**

**than one officer or employee of the holding company serves as a director or trustee (or individual exercising similar functions) of the company; or**

**(3) A person that is not affiliated or associated with the holding company owns or controls more than 50 percent of the voting shares of the company, and officers and employees of the holding company do not constitute a majority of the directors or trustees (or individuals exercising similar functions) of the company; and**

**(B) The company is not otherwise an affiliate under this section.**

**(iv) <u>Application of rule to private equity funds</u>. A holding company will not be deemed to own or control the equity capital of a company for purposes of paragraph (a)(9)(i) of this section solely by virtue of an investment made by the holding company in a private equity fund (as defined in the merchant banking subpart of the Board's Regulation Y (12 CFR 225.173(a))) that owns or controls the equity capital of the company unless the holding company controls the private equity fund under 12 CFR 225.173(d)(4).**

**(v) <u>Definition</u>. For purposes of this paragraph (a)(9), "<u>holding company</u>" with respect to a member bank means a company that controls the member bank, or a company that is controlled by shareholders that control the member bank, and all subsidiaries of the company (including any depository institution that is a subsidiary of the company).**

**(10) <u>Partnerships associated with the member bank or an affiliate</u>. Any partnership for which the member bank or any affiliate of the member bank serves as a general partner or for which the member bank or any affiliate of the member bank causes any director, officer, or employee of the member bank or affiliate to serve as a general partner;**

**(11) <u>Subsidiaries of affiliates</u>. Any subsidiary of a company described in paragraphs (a)(1) through (10) of this section; and**

(12) Other companies. Any company that the Board determines by regulation or order**, or that the appropriate Federal banking agency for the member bank determines by order,** to have a relationship with the member bank, or any affiliate of the member bank, such that covered transactions by the member bank with that company may be affected by the relationship to the detriment of the member bank. **A member bank may petition the Board for review of any such affiliate determination made by the member bank's appropriate Federal banking agency under 12 CFR 265.3.**

(b) "Affiliate" with respect to a member bank does not include:

(1) Subsidiaries. Any company that is a subsidiary of the member bank, unless the company is:

(i) A **depository institution**;

(ii) A financial subsidiary;

**(iii) Directly controlled by:**

**(A) One or more affiliates (other than depository institution affiliates) of the member bank; or**

**(B) A shareholder that controls the member bank or a group of shareholders that together control the member bank;**

**(iv) An employee stock option plan, trust, or similar organization that exists for the benefit of the shareholders, partners, members, or employees of the member bank or any of its affiliates;** or

(v) Any other company determined to be an affiliate under paragraph (a)(12) of this section;

(2) Bank premises. Any company engaged solely in holding the premises of the member bank;

(3) Safe deposit. Any company engaged solely in conducting a safe deposit business;

(4) Government securities. Any company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and

(5) Companies held DPC. Any company where control results from the exercise of rights arising out of a bona fide debt previously contracted. This exclusion from the definition of "affiliate" applies only for the period of time specifically authorized under applicable State or Federal law or regulation or, in the absence of such law or regulation, for a period of two years from the date of the exercise of such rights. The Board may authorize, upon application and for good cause shown, extensions of time for not more than one year at a time, but such extensions in the aggregate will not exceed three years.

(c) For purposes of subpart F (implementing section 23B), "affiliate" with respect to a member bank also does not include any **depository institution**.

**§ 223.3 What are the meanings of the other terms used in sections 23A and 23B and this regulation?**

For purposes of this part:

(a) "Aggregate amount of covered transactions" means the amount of the covered transaction about to be engaged in added to the current amount of all outstanding covered transactions.

**(b) "Appropriate Federal banking agency" with respect to a member bank or other depository institution has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).**

**(c) "Bank holding company" has the same meaning as in 12 CFR 225.2.**

**(d) "Capital stock and surplus" means the sum of:**

**(1) A member bank's tier 1 and tier 2 capital under the risk-based capital guidelines of the appropriate Federal banking agency, based on the**

**member bank's most recent consolidated Report of Condition and Income filed under 12 U.S.C. 1817(a)(3);**

**(2) The balance of a member bank's allowance for loan and lease losses not included in its tier 2 capital under the risk-based capital guidelines of the appropriate Federal banking agency, based on the member bank's most recent consolidated Report of Condition and Income filed under 12 U.S.C. 1817(a)(3); and**

**(3) The amount of any investment by a member bank in a financial subsidiary that counts as a covered transaction and is required to be deducted from the member bank's capital for regulatory capital purposes.**

**(e) "Carrying value" with respect to a security means the value of the security on the financial statements of the member bank, determined in accordance with GAAP.**

(f) "Company" means a corporation, partnership, **limited liability company,** business trust, association, or similar organization and, unless specifically excluded, includes a member bank and a **depository institution.**

(g) Control. (1) In general. "Control" by a company or shareholder over another company means that:

(i) The company or shareholder, directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company;

(ii) The company or shareholder controls in any manner the election of a majority of the directors, trustees, **or general partners (or individuals exercising similar functions)** of the other company; or

(iii) The Board determines, after notice and opportunity for hearing, that the company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company.

(2) Ownership or control of shares as fiduciary. Notwithstanding any other provision of this regulation, no company will be deemed to control another company by virtue of its ownership or control of shares in a fiduciary capacity, except as provided in paragraph (a)(3) of § 223.2 or if the company owning or controlling the shares is a business trust.

**(3) Ownership or control of securities by subsidiary. A company controls securities, assets, or other ownership interests owned or controlled, directly or indirectly, by any subsidiary (including a subsidiary depository institution) of the company.**

**(4) Ownership or control of convertible instruments. A company or shareholder that owns or controls instruments (including options or warrants) that are convertible or exercisable, at the option of the holder or owner, into securities, controls the securities, unless the company or shareholder presents information to the Board that demonstrates, to the Board's satisfaction, that the company or shareholder should not be deemed to control the securities.**

**(5) Ownership or control of nonvoting securities. A company or shareholder that owns or controls 25 percent or more of the equity capital of another company controls the other company, unless the company or shareholder presents information to the Board that demonstrates, to the Board's satisfaction, that the company or shareholder does not control the other company.**

(h) "Covered transaction" with respect to an affiliate means:

(1) An extension of credit to the affiliate;

(2) A purchase of, or an investment in, a security issued by the affiliate;

(3) A purchase of an asset from the affiliate, including an asset subject to **recourse or** an agreement to repurchase, except such purchases of real and

personal property as may be specifically exempted by the Board by order or regulation;

(4) The acceptance of a security issued by the affiliate as collateral for an extension of credit to any person or company; and

(5) The issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of the affiliate, **a confirmation of a letter of credit issued by the affiliate, and a cross-affiliate netting arrangement.**

**(i) "Credit transaction" with an affiliate means:**

**(1) An extension of credit to the affiliate;**

**(2) An issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of the affiliate and a confirmation of a letter of credit issued by the affiliate; and**

**(3) A cross-affiliate netting arrangement.**

**(j) "Cross-affiliate netting arrangement" means an arrangement among a member bank, one or more affiliates of the member bank, and one or more nonaffiliates of the member bank in which:**

**(1) A nonaffiliate is permitted to deduct any obligations of an affiliate of the member bank to the nonaffiliate when settling the nonaffiliate's obligations to the member bank; or**

**(2) The member bank is permitted or required to add any obligations of its affiliate to a nonaffiliate when determining the member bank's obligations to the nonaffiliate.**

**(k) "Depository institution" means, unless otherwise noted, an insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), but does not include any branch of a foreign bank. For**

**purposes of this definition, an operating subsidiary of a depository institution is treated as part of the depository institution.**

**(l) "Derivative transaction" means any derivative contract listed in sections III.E.1.a. through d. of appendix A to 12 CFR part 225 and any similar derivative contract, including a credit derivative contract.**

**(m) "Eligible affiliated mutual fund securities" has the meaning specified in paragraph (c)(2) of § 223.24.**

**(n) "Equity capital" means:**

**(1) With respect to a corporation, preferred stock, common stock, capital surplus, retained earnings, and accumulated other comprehensive income, less treasury stock, plus any other account that constitutes equity of the corporation; and**

**(2) With respect to a partnership, limited liability company, or other company, equity accounts similar to those described in paragraph (n)(1) of this section.**

**(o) "Extension of credit" to an affiliate means the making or renewal of a loan, the granting of a line of credit, or the extending of credit in any manner whatsoever, including on an intraday basis, to an affiliate. An extension of credit to an affiliate includes, without limitation:**

**(1) An advance to an affiliate by means of an overdraft, cash item, or otherwise;**

**(2) A sale of Federal funds to an affiliate;**

**(3) A lease that is the functional equivalent of an extension of credit to an affiliate;**

**(4) An acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other debt securities, of an affiliate;**

**(5) Any increase in the amount of, extension of the maturity of, or adjustment to the interest rate term or other material term of, an extension of credit to an affiliate; and**

**(6) Any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent).**

**(p) "<u>Financial subsidiary</u>"**

**(1) <u>In general</u>. Except as provided in paragraph (2), the term "<u>financial subsidiary</u>" means any subsidiary of a member bank that:**

**(i) 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**

**(ii) 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.**

**(2) <u>Exceptions</u>. "<u>Financial subsidiary</u>" does not include:**

**(i) A subsidiary of a member bank that is considered a financial subsidiary under paragraph (p)(1) of this section solely because the subsidiary engages in the sale of insurance as agent or broker in a manner that is not permitted for national banks; and**

**(ii) A subsidiary of a State bank (other than a subsidiary described in section 46(a) of the Federal Deposit Insurance Act (12 U.S.C. 1831w(a))) that is considered a financial subsidiary under paragraph (p)(1) of this section solely because the subsidiary engages in one or more of the following activities:**

**(A) Activities that the State bank is permitted to engage in directly under applicable Federal and State law and that are conducted under the**

**same terms and conditions that govern the conduct of such activities by the State bank; and**

**(B) Activities that the subsidiary was authorized by applicable Federal and State law to conduct prior to [date of publication in Federal Register], and that were lawfully conducted by the subsidiary on that date.**

**(3) Subsidiaries of financial subsidiaries. If a company is a financial subsidiary under paragraphs (p)(1) and (p)(2) of this section, any subsidiary of such a company is also a financial subsidiary.**

**(q) "Foreign bank" and an "agency," "branch," or "commercial lending company" of a foreign bank have the same meanings as in section 1(b) of the International Banking Act of 1978 (12 U.S.C. 3101).**

**(r) "GAAP" means U.S. generally accepted accounting principles.**

**(s) "General purpose credit card" has the meaning specified in paragraph (c)(4)(ii) of § 223.16.**

**(t) In contemplation. A transaction between a member bank and a nonaffiliate is presumed to be "in contemplation" of the nonaffiliate becoming an affiliate of the member bank if the member bank enters into the transaction with the nonaffiliate after the execution of, or commencement of negotiations designed to result in, an agreement under the terms of which the nonaffiliate would become an affiliate.**

(u) "Low-quality asset" means:

(1) An asset **(including a security)** classified as "substandard," "doubtful," or "loss," or treated as "special mention" **or "other transfer risk problems," either** in the most recent report of examination or inspection of an affiliate prepared by either a Federal or State supervisory agency **or in any internal classification system used by the member bank or the affiliate (including an**

**asset that receives a rating that is substantially equivalent to "classified" or "special mention" in the internal system of the member bank or affiliate);**

(2) An asset in a nonaccrual status;

(3) An asset on which principal or interest payments are more than thirty days past due;

(4) An asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor; and

**(5) An asset acquired through foreclosure, repossession, or otherwise in satisfaction of a debt previously contracted, if the asset has not yet been reviewed in an examination or inspection.**

**(v) "<u>Member bank</u>" means any national bank, State bank, banking association, or trust company that is a member of the Federal Reserve System. For purposes of this definition, an operating subsidiary of a member bank is treated as part of the member bank.**

**(w) "<u>Municipal securities</u>" has the same meaning as in section 3(a)(29) of the Securities Exchange Act of 1934 (17 U.S.C. 78c(a)(29)).**

**(x) "<u>Nonaffiliate</u>" with respect to a member bank means any person that is not an affiliate of the member bank.**

**(y) "<u>Obligations of, or fully guaranteed as to principal and interest by, the United States or its agencies</u>" includes those obligations listed in 12 CFR 201.108(b) and any additional obligations as determined by the Board. The term does not include Federal Housing Administration or Veterans Administration loans.**

**(z) "<u>Operating subsidiary</u>" with respect to a member bank or other depository institution means any subsidiary of the member bank or depository institution other than a subsidiary described in paragraphs (b)(1)(i) through (v) of § 223.2.**

**(aa) "Person" means an individual, company, trust, joint venture, pool, syndicate, sole proprietorship, unincorporated organization, or any other form of entity.**

(bb) "Principal underwriter" has the meaning specified in paragraph (c)(1) of § 223.53.

**(cc) "Purchase of an asset" by a member bank from an affiliate means the acquisition by a member bank of an asset from an affiliate in exchange for cash or any other consideration, including an assumption of liabilities. The merger of an affiliate into a member bank is a purchase of assets by the member bank from an affiliate if the member bank assumes any liabilities of the affiliate or pays any other form of consideration in the transaction.**

**(dd) Riskless principal. A company is "acting exclusively as a riskless principal" if, after receiving an order to buy (or sell) a security from a customer, the company purchases (or sells) the security in the secondary market for its own account to offset a contemporaneous sale to (or purchase from) the customer.**

(ee) "Securities" means stocks, bonds, debentures, notes, or similar obligations **(including commercial paper).**

**(ff) "Securities affiliate" with respect to a member bank means:**

**(1) An affiliate of the member bank that is registered with the Securities and Exchange Commission as a broker or dealer; or**

**(2) Any other securities broker or dealer affiliate of a member bank that is approved by the Board.**

**(gg) "State bank" has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).**

(hh) "Subsidiary" with respect to a specified company means a company that is controlled by the specified company.

**(ii) "Voting securities" has the same meaning as in 12 CFR 225.2.**

**(jj) "Well capitalized" has the same meaning as in 12 CFR 225.2 and, in the case of any holding company that is not a bank holding company, "well capitalized" means that the holding company has and maintains at least the capital levels required for a bank holding company to be well capitalized under 12 CFR 225.2.**

**(kk) "Well managed" has the same meaning as in 12 CFR 225.2.**

**Subpart B–General Provisions of Section 23A**

**§ 223.11 What is the maximum amount of covered transactions that a member bank may enter into with any single affiliate?**

A member bank may not engage in a covered transaction with an affiliate **(other than a financial subsidiary of the member bank)** if the aggregate amount of the member bank's covered transactions with **such** affiliate would exceed 10 percent of the capital stock and surplus of the member bank.

**§ 223.12 What is the maximum amount of covered transactions that a member bank may enter into with all affiliates?**

A member bank may not engage in a covered transaction with any affiliate if the aggregate amount of the member bank's covered transactions with all affiliates would exceed 20 percent of the capital stock and surplus of the member bank.

**§ 223.13 What safety and soundness requirement applies to covered transactions?**

A member bank may not engage in any covered transaction, including any transaction exempt under **this regulation**, unless the transaction is on terms and conditions that are consistent with safe and sound banking practices.

**§ 223.14 What are the collateral requirements for a credit transaction with an affiliate?**

(a) Collateral required for extensions of credit and certain other covered transactions. A member bank must ensure that each of its **credit transactions** with an affiliate is secured by the amount of collateral required by paragraph (b) of this section at the time of the transaction.

(b) Amount of collateral required. (1) The rule. A credit transaction described in paragraph (a) of this section must be secured by collateral having a market value equal to at least:

(i) 100 percent of the amount of the transaction, if the collateral is:

(A) Obligations of the United States or its agencies;

(B) Obligations fully guaranteed by the United States or its agencies as to principal and interest;

(C) Notes, drafts, bills of exchange, or bankers' acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank; or

(D) A segregated, earmarked deposit account with the member bank **that is for the sole purpose of securing credit transactions between the member bank and its affiliates and is identified as such**;

(ii) 110 percent of the amount of the transaction, if the collateral is obligations of any State or political subdivision of any State;

(iii) 120 percent of the amount of the transaction, if the collateral is other debt instruments, including **loans and other** receivables; or

(iv) 130 percent of the amount of the transaction, if the collateral is stock, leases, or other real or personal property.

**(2) Example. A member bank makes a $1,000 loan to an affiliate. The affiliate posts as collateral for the loan $500 in U.S. Treasury securities, $480 in corporate debt securities, and $130 in real estate. The loan satisfies the collateral requirements of this section because $500 of the loan is 100 percent secured by obligations of the United States, $400 of the loan is 120 percent**

**secured by debt instruments, and $100 of the loan is 130 percent secured by real estate.**

**(c) <u>Ineligible collateral</u>.** The following items are not eligible collateral for purposes of this section:

(1) Low-quality assets;

(2) Securities issued by any affiliate;

**(3) Equity securities issued by the member bank, and debt securities issued by the member bank that represent regulatory capital of the member bank;**

**(4) Intangible assets (including servicing assets), unless specifically approved by the Board; and**

**(5) Guarantees, letters of credit, and other similar instruments.**

**(d) <u>Perfection and priority requirements for collateral</u>. (1) <u>Perfection</u>. A member bank must maintain a security interest in collateral required by this section that is perfected and enforceable under applicable law, including in the event of default resulting from bankruptcy, insolvency, liquidation, or similar circumstances.**

**(2) <u>Priority</u>. A member bank either must obtain a first priority security interest in collateral required by this section or must deduct from the value of collateral obtained by the member bank the lesser of:**

**(i) The amount of any security interest in the collateral that is senior to that of the member bank; or**

**(ii) The amount of any credit secured by the collateral that is senior to that of the member bank.**

**(3) <u>Example</u>. A member bank makes a $2,000 loan to an affiliate. The affiliate grants the member bank a second priority security interest in a piece of real estate valued at $3,000. Another institution that previously lent $1,000**

**to the affiliate has a first priority security interest in the entire parcel of real estate. This transaction is not in compliance with the collateral requirements of this section. Due to the existence of the prior third-party lien on the real estate, the effective value of the real estate collateral for the member bank for purposes of this section is only $2,000 -- $600 less than the amount of real estate collateral required by this section for the transaction ($2,000 x 130 percent = $2,600).**

(e) <u>Replacement requirement for retired or amortized collateral</u>. A member bank must **ensure that** any required collateral that subsequently is retired or amortized **is replaced** with additional eligible collateral as needed to keep the percentage of the collateral value relative to the amount of the outstanding **credit transaction** equal to the minimum percentage required at the inception of the transaction.

(f) <u>Inapplicability of the collateral requirements to certain transactions</u>. The collateral requirements of this section do not apply to the following transactions.

(1) <u>Acceptances</u>. An acceptance that already is fully secured either by attached documents or by other property that is involved in the transaction and has an ascertainable market value.

**(2) <u>The unused portion of certain extensions of credit</u>. The unused portion of an extension of credit to an affiliate as long as the member bank does not have any legal obligation to advance additional funds under the extension of credit until the affiliate provides the amount of collateral required by paragraph (b) of this section with respect to the entire used portion (including the amount of the requested advance) of the extension of credit.**

**(3) <u>Purchases of affiliate debt securities in the secondary market</u>. The purchase of a debt security issued by an affiliate as long as the member bank**

**purchases the debt security from a nonaffiliate in a bona fide secondary market transaction.**

**§ 223.15 May a member bank purchase a low-quality asset from an affiliate?**

(a) In general. A member bank may not purchase a low-quality asset from an affiliate unless, pursuant to an independent credit evaluation, the member bank had committed itself to purchase the asset **before** the time the asset was acquired by the affiliate.

**(b) Exemption for renewals of loan participations involving problem loans. The prohibition contained in paragraph (a) of this section does not apply to the renewal of, or extension of additional credit with respect to, a member bank's participation in a loan to a nonaffiliate that was originated by an affiliate if:**

**(1) The loan was not a low-quality asset at the time the member bank purchased its participation;**

**(2) The renewal or extension of additional credit is approved, as necessary to protect the participating member bank's investment by enhancing the ultimate collection of the original indebtedness, by the board of directors of the participating member bank or, if the originating affiliate is a depository institution, by:**

**(i) An executive committee of the board of directors of the participating member bank; or**

**(ii) One or more senior management officials of the participating member bank, if:**

**(A) The board of directors of the member bank approves standards for the member bank's renewals or extensions of additional credit described in this paragraph (b), based on the determination set forth in paragraph (b)(2) of this section;**

**(B) Each renewal or extension of additional credit described in this paragraph (b) meets the standards; and**

**(C) The board of directors of the member bank periodically reviews renewals and extensions of additional credit described in this paragraph (b) to ensure that they meet the standards and periodically reviews the standards to ensure that they continue to meet the criterion set forth in paragraph (b)(2) of this section;**

**(3) The participating member bank's share of the renewal or extension of additional credit does not exceed its proportional share of the original transaction by more than 5 percent, unless the member bank obtains the prior written approval of its appropriate Federal banking agency; and**

**(4) The participating member bank provides its appropriate Federal banking agency with written notice of the renewal or extension of additional credit not later than 20 days after consummation.**

**§ 223.16 What transactions by a member bank with any person are treated as transactions with an affiliate?**

(a) In general. A member bank must treat any of its transactions with any person as a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate.

**(b) Certain agency transactions. (1) Except to the extent described in paragraph (b)(2) of this section, an extension of credit by a member bank to a nonaffiliate is not treated as an extension of credit to an affiliate under paragraph (a) of this section if:**

**(i) The proceeds of the extension of credit are used to purchase an asset through an affiliate of the member bank, and the affiliate is acting exclusively as an agent or broker in the transaction; and**

**(ii) The asset purchased by the nonaffiliate is not issued, underwritten, or sold as principal by any affiliate of the member bank.**

**(2) The interpretation set forth in paragraph (b)(1) of this section does not apply to the extent of any agency fee, brokerage commission, or other compensation received by an affiliate from the proceeds of the extension of credit. The receipt of such compensation may qualify, however, for the exemption contained in paragraph (c)(2) of this section.**

**(c) <u>Exemptions</u>. Notwithstanding paragraph (a) of this section, the following transactions are not subject to the quantitative limits of §§ 223.11 and 223.12 or the collateral requirements of § 223.14. The transactions are, however, subject to the safety and soundness requirement of § 223.13 and the market terms requirement and other provisions of subpart F (implementing section 23B).**

**(1) <u>Certain riskless principal transactions</u>. An extension of credit by a member bank to a nonaffiliate, if:**

**(i) The proceeds of the extension of credit are used to purchase a security through a securities affiliate of the member bank, and the securities affiliate is acting exclusively as a riskless principal in the transaction;**

**(ii) The security purchased by the nonaffiliate is not issued, underwritten, or sold as principal (other than as riskless principal) by any affiliate of the member bank; and**

**(iii) Any riskless principal mark-up or other compensation received by the securities affiliate from the proceeds of the extension of credit meets the market terms standard set forth in paragraph (c)(2) of this section.**

**(2) <u>Brokerage commissions, agency fees, and riskless principal mark-ups</u>. An affiliate's retention of a portion of the proceeds of an extension of credit described in paragraph (b) or (c)(1) of this section as a brokerage**

**commission, agency fee, or riskless principal mark-up, if that commission, fee, or mark-up is substantially the same as, or lower than, those prevailing at the same time for comparable transactions with or involving other nonaffiliates, in accordance with the market terms requirement of § 223.51.**

**(3) Preexisting lines of credit. An extension of credit by a member bank to a nonaffiliate, if:**

**(i) The proceeds of the extension of credit are used to purchase a security from or through a securities affiliate of the member bank; and**

**(ii) The extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit that was not established in contemplation of the purchase of securities from or through an affiliate of the member bank.**

**(4) General purpose credit card transactions.**

**(i) In general. An extension of credit by a member bank to a nonaffiliate, if:**

**(A) The proceeds of the extension of credit are used by the nonaffiliate to purchase a product or service from an affiliate of the member bank; and**

**(B) The extension of credit is made pursuant to, and consistent with any conditions imposed in, a general purpose credit card issued by the member bank to the nonaffiliate.**

**(ii) Definition. "General purpose credit card" means a credit card issued by a member bank if:**

**(A) The card is widely accepted by merchants that are not affiliates of the member bank for the purchase of products or services; and**

**(B) (1) Less than 25 percent of the total value of products and services purchased with the card by all cardholders are purchases of products and services from one or more affiliates of the member bank;**

**(2) All affiliates of the member bank would be permissible for a financial holding company (as defined in 12 U.S.C. 1841) under section 4 of the Bank Holding Company Act (12 U.S.C. 1843), and the member bank has no reason to believe that 25 percent or more of the total value of products and services purchased with the card by all cardholders are or would be purchases of products and services from one or more affiliates of the member bank; or**

**(3) The member bank presents information to the Board that demonstrates, to the Board's satisfaction, that less than 25 percent of the total value of products and services purchased with the card by all cardholders are and would be purchases of products and services from one or more affiliates of the member bank.**

**(iii) Calculating compliance. To determine whether a credit card qualifies as a general purpose credit card under the standard set forth in paragraph (c)(4)(ii)(B)(1) of this section, a member bank must compute compliance on a monthly basis, based on cardholder purchases that were financed by the credit card during the preceding 12 calendar months. If a credit card has qualified as a general purpose credit card for 3 consecutive months but then ceases to qualify in the following month, the member bank may continue to treat the credit card as a general purpose credit card for such month and three additional months (or such longer period as may be permitted by the Board).**

**(iv) Example of calculating compliance with the 25 percent test. A member bank seeks to qualify a credit card as a general purpose credit card under paragraph (c)(4)(ii)(B)(1) of this section. The member bank assesses its compliance under paragraph (c)(4)(iii) of this section on the 15th day of every month. On May 15, 2005, the member bank determines that, for the period from May 1, 2004, through April 30, 2005, the total value of products and**

**services purchased with the card by all cardholders was $1 million, and the total value of products and services purchased with the card by all cardholders from an affiliate of the member bank was $220,000. Because 22 percent of the total value of products and services purchased with the card by all cardholders were purchases of products and services from an affiliate of the member bank, the card qualifies as a general purpose credit card until June 15, 2005. On June 15, 2005, the member bank determines that, for the period from June 1, 2004, through May 31, 2005, 27 percent of the total value of products and services purchased with the card by all cardholders were purchases of products and services from an affiliate of the member bank. The card will cease to qualify as a general purpose credit card as of September 15, 2005. Any outstanding extensions of credit under the credit card that were used to purchase products or services from an affiliate of the member bank would become covered transactions at such time.**

**Subpart C–Valuation and Timing Principles under Section 23A**

**§ 223.21 What valuation and timing principles apply to credit transactions?**

**(a) Valuation. (1) Initial valuation. Except as provided in paragraph (a)(2) or (3) of this section, a credit transaction with an affiliate initially must be valued at the greater of:**

**(i) The principal amount of the transaction;**

**(ii) The amount owed by the affiliate to the member bank under the transaction; or**

**(iii) The sum of:**

**(A) The amount provided to, or on behalf of, the affiliate in the transaction; and**

**(B) Any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.**

**(2) <u>Initial valuation of certain acquisitions of a credit transaction</u>. If a member bank acquires from a nonaffiliate a credit transaction with an affiliate, the covered transaction initially must be valued at the sum of:**

**(i) The total amount of consideration given (including liabilities assumed) by the member bank in exchange for the credit transaction; and**

**(ii) Any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.**

**(3) <u>Debt securities</u>. The valuation principles of paragraphs (a)(1) and (2) of this section do not apply to a member bank's purchase of or investment in a debt security issued by an affiliate, which is governed by § 223.23.**

**(4) <u>Examples</u>. The following are examples of how to value a member bank's credit transactions with an affiliate.**

**(i) <u>Term loan</u>. A member bank makes a loan to an affiliate that has a principal amount of $100. The affiliate pays $2 in up-front fees to the member bank, and the affiliate receives net loan proceeds of $98. The member bank must initially value the covered transaction at $100.**

**(ii) <u>Revolving credit</u>. A member bank establishes a $300 revolving credit facility for an affiliate. The affiliate has drawn down $100 under the facility. The member bank must value the covered transaction at $300 throughout the life of the facility.**

**(iii) <u>Guarantee</u>. A member bank has issued a guarantee to a nonaffiliate on behalf of an affiliate under which the member bank would be obligated to pay the nonaffiliate $500 if the affiliate defaults on an issuance of debt securities. The member bank must value the guarantee at $500 throughout the life of the guarantee.**

**(iv) <u>Acquisition of a loan to an affiliate</u>. A member bank purchases from a nonaffiliate a fixed-rate loan to an affiliate. The loan has an**

**outstanding principal amount of $100 but, due to movements in the general level of interest rates since the time of the loan's origination, the member bank is able to purchase the loan for $90. The member bank initially must value the credit transaction at $90 (and must ensure that the credit transaction complies with the collateral requirements of § 223.14 at the time of its acquisition of the loan).**

**(b) <u>Timing</u>. (1) <u>In general</u>. A member bank engages in a credit transaction with an affiliate at the time during the day that:**

**(i) The member bank becomes legally obligated to make an extension of credit to, issue a guarantee, acceptance, or letter of credit on behalf of, or confirm a letter of credit issued by, an affiliate;**

**(ii) The member bank enters into a cross-affiliate netting arrangement; or**

**(iii) The member bank acquires an extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate.**

**(2) <u>Credit transactions by a member bank with a nonaffiliate that becomes an affiliate of the member bank</u>.**

**(i) <u>In general</u>. A credit transaction with a nonaffiliate becomes a covered transaction at the time that the nonaffiliate becomes an affiliate of the member bank. The member bank must treat the amount of any such credit transaction as part of the aggregate amount of the member bank's covered transactions for purposes of determining compliance with the quantitative limits of §§ 223.11 and 223.12 in connection with any future covered transactions. Except as described in paragraph (b)(2)(ii) of this section, the member bank is not required to reduce the amount of its covered transactions with any affiliate because the nonaffiliate has become an affiliate. If the nonaffiliate becomes an affiliate less than one year after the member bank**

**enters into the credit transaction with the nonaffiliate, the member bank also must ensure that the credit transaction complies with the collateral requirements of § 223.14 promptly after the nonaffiliate becomes an affiliate.**

**(ii) <u>Credit transactions by a member bank with a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the member bank</u>. Notwithstanding the provisions of paragraph (b)(2)(i) of this section, if a member bank engages in a credit transaction with a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the member bank, the member bank must ensure that:**

**(A) The aggregate amount of the member bank's covered transactions (including any such credit transaction with the nonaffiliate) would not exceed the quantitative limits of § 223.11 or 223.12 at the time the nonaffiliate becomes an affiliate; and**

**(B) The credit transaction complies with the collateral requirements of § 223.14 at the time the nonaffiliate becomes an affiliate.**

**(iii) <u>Example</u>. A member bank with capital stock and surplus of $1,000 and no outstanding covered transactions makes a $120 unsecured loan to a nonaffiliate. The member bank does not make the loan in contemplation of the nonaffiliate becoming an affiliate. Nine months later, the member bank's holding company purchases all the stock of the nonaffiliate, thereby making the nonaffiliate an affiliate of the member bank. The member bank is not in violation of the quantitative limits of § 223.11 or 223.12 at the time of the stock acquisition. The member bank is, however, prohibited from engaging in any additional covered transactions with the new affiliate at least until such time as the value of the loan transaction falls below 10 percent of the member bank's capital stock and surplus. In addition, the member bank must bring**

**the loan into compliance with the collateral requirements of § 223.14 promptly after the stock acquisition.**

**§ 223.22 What valuation and timing principles apply to asset purchases?**

**(a) <u>Valuation</u>. (1) <u>In general</u>. Except as provided in paragraph (a)(2) of this section, a purchase of an asset by a member bank from an affiliate must be valued initially at the total amount of consideration given (including liabilities assumed) by the member bank in exchange for the asset. The value of the covered transaction after the purchase may be reduced to reflect amortization or depreciation of the asset, to the extent that such reductions are consistent with GAAP.**

**(2) <u>Exceptions</u>. (i) <u>Purchase of an extension of credit to an affiliate</u>. A purchase from an affiliate of an extension of credit to an affiliate must be valued in accordance with § 223.21, unless the note or obligation evidencing the extension of credit is a security issued by an affiliate (in which case the transaction must be valued in accordance with § 223.23).**

**(ii) <u>Purchase of a security issued by an affiliate</u>. A purchase from an affiliate of a security issued by an affiliate must be valued in accordance with § 223.23.**

**(iii) <u>Transfer of a subsidiary</u>. A transfer to a member bank of securities issued by an affiliate that is treated as a purchase of assets from an affiliate under § 223.31 must be valued in accordance with paragraph (b) of § 223.31.**

**(iv) <u>Purchase of a line of credit</u>. A purchase from an affiliate of a line of credit, revolving credit facility, or other similar credit arrangement for a nonaffiliate must be valued initially at the total amount of consideration given by the member bank in exchange for the asset plus any additional amount that the member bank could be required to provide to the borrower under the terms of the credit arrangement.**

**(b) Timing. (1) In general. A purchase of an asset remains a covered transaction for a member bank for as long as the member bank holds the asset.**

**(2) Asset purchases by a member bank from a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the member bank. If a member bank purchases an asset from a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the member bank, the asset purchase becomes a covered transaction at the time that the nonaffiliate becomes an affiliate of the member bank. In addition, the member bank must ensure that the aggregate amount of the member bank's covered transactions (including any such transaction with the nonaffiliate) would not exceed the quantitative limits of § 223.11 or 223.12 at the time the nonaffiliate becomes an affiliate.**

**(c) Examples. The following are examples of how to value a member bank's purchase of an asset from an affiliate.**

**(1) Cash purchase of assets. A member bank purchases a pool of loans from an affiliate for $10 million. The member bank initially must value the covered transaction at $10 million. Going forward, if the borrowers repay $6 million of the principal amount of the loans, the member bank may value the covered transaction at $4 million.**

**(2) Purchase of assets through an assumption of liabilities. An affiliate of a member bank contributes real property with a fair market value of $200,000 to the member bank. The member bank pays the affiliate no cash for the property, but assumes a $50,000 mortgage on the property. The member bank has engaged in a covered transaction with the affiliate and initially must value the transaction at $50,000. Going forward, if the member bank retains the real property but pays off the mortgage, the member bank must continue to value the covered transaction at $50,000. If the member**

**bank, however, sells the real property (regardless of the status of the mortgage), the transaction ceases to be a covered transaction at the time of the sale.**

**§ 223.23 What valuation and timing principles apply to purchases of and investments in securities issued by an affiliate?**

**(a) Valuation. (1) In general. Except as provided in paragraph (b) of § 223.32 with respect to financial subsidiaries, a member bank's purchase of or investment in a security issued by an affiliate must be valued at the greater of:**

**(i) The total amount of consideration given (including liabilities assumed) by the member bank in exchange for the security, reduced to reflect amortization of the security to the extent consistent with GAAP; or**

**(ii) The carrying value of the security.**

**(2) Examples. The following are examples of how to value a member bank's purchase of or investment in securities issued by an affiliate (other than a financial subsidiary of the member bank).**

**(i) Purchase of the debt securities of an affiliate. The parent holding company of a member bank owns 100 percent of the shares of a mortgage company. The member bank purchases debt securities issued by the mortgage company for $600. The initial carrying value of the securities is $600. The member bank initially must value the investment at $600.**

**(ii) Purchase of the shares of an affiliate. The parent holding company of a member bank owns 51 percent of the shares of a mortgage company. The member bank purchases an additional 30 percent of the shares of the mortgage company from a third party for $100. The initial carrying value of the shares is $100. The member bank initially must value the investment at $100. Going forward, if the member bank's carrying value of the shares**

**declines to $40, the member bank must continue to value the investment at $100.**

**(iii) Contribution of the shares of an affiliate. The parent holding company of a member bank owns 100 percent of the shares of a mortgage company and contributes 30 percent of the shares to the member bank. The member bank gives no consideration in exchange for the shares. If the initial carrying value of the shares is $300, then the member bank initially must value the investment at $300. Going forward, if the member bank's carrying value of the shares increases to $500, the member bank must value the investment at $500.**

**(b) Timing. (1) In general. A purchase of or investment in a security issued by an affiliate remains a covered transaction for a member bank for as long as the member bank holds the security.**

**(2) A member bank's purchase of or investment in a security issued by a nonaffiliate that becomes an affiliate of the member bank. A member bank's purchase of or investment in a security issued by a nonaffiliate that becomes an affiliate of the member bank must be treated according to the same transition rules that apply to credit transactions described in paragraph (b)(2) of § 223.21.**

**§ 223.24 What valuation principles apply to extensions of credit secured by affiliate securities?**

**(a) Valuation of extensions of credit secured exclusively by affiliate securities. An extension of credit by a member bank to a nonaffiliate secured exclusively by securities issued by an affiliate of the member bank must be valued at the lesser of:**

**(1) The total value of the extension of credit; or**

**(2) The fair market value of the securities issued by an affiliate that are pledged as collateral, if the member bank verifies that such securities meet the market quotation standard contained in paragraph (e) of § 223.42 or the standards set forth in paragraphs (f)(1) and (5) of § 223.42.**

**(b) Valuation of extensions of credit secured by affiliate securities and other collateral. An extension of credit by a member bank to a nonaffiliate secured in part by securities issued by an affiliate of the member bank and in part by nonaffiliate collateral must be valued at the lesser of:**

**(1) The total value of the extension of credit less the fair market value of the nonaffiliate collateral; or**

**(2) The fair market value of the securities issued by an affiliate that are pledged as collateral, if the member bank verifies that such securities meet the market quotation standard contained in paragraph (e) of § 223.42 or the standards set forth in paragraphs (f)(1) and (5) of § 223.42.**

**(c) Exclusion of eligible affiliated mutual fund securities. (1) The exclusion. Eligible affiliated mutual fund securities are not considered to be securities issued by an affiliate, and are instead considered to be nonaffiliate collateral, for purposes of paragraphs (a) and (b) of this section, unless the member bank knows or has reason to know that the proceeds of the extension of credit will be used to purchase the eligible affiliated mutual fund securities collateral or will otherwise be used for the benefit of or transferred to an affiliate of the member bank.**

**(2) Definition. "Eligible affiliated mutual fund securities" with respect to a member bank are securities issued by an affiliate of the member bank that is an open-end investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), if:**

**(i) The securities issued by the investment company:**

**(A) Meet the market quotation standard contained in paragraph (e) of § 223.42;**

**(B) Meet the standards set forth in paragraphs (f)(1) and (5) of § 223.42; or**

**(C) Have closing prices that are made public through a mutual fund "supermarket" website maintained by an unaffiliated securities broker-dealer or mutual fund distributor; and**

**(ii) The member bank and its affiliates do not own or control in the aggregate more than 5 percent of any class of voting securities or of the equity capital of the investment company (excluding securities held by the member bank or an affiliate in good faith in a fiduciary capacity, unless the member bank or affiliate holds the securities for the benefit of the member bank or affiliate, or the shareholders, employees, or subsidiaries of the member bank or affiliate).**

**(3) <u>Example</u>. A member bank proposes to lend $100 to a nonaffiliate secured exclusively by eligible affiliated mutual fund securities. The member bank knows that the nonaffiliate intends to use all the loan proceeds to purchase the eligible affiliated mutual fund securities that would serve as collateral for the loan. Under the attribution rule in § 223.16, the member bank must treat the loan to the nonaffiliate as a loan to an affiliate, and, because securities issued by an affiliate are ineligible collateral under § 223.14, the loan would not be in compliance with § 223.14.**

## Subpart D–Other Requirements under Section 23A

### § 223.31 How does section 23A apply to a member bank's acquisition of an affiliate that becomes an operating subsidiary of the member bank after the acquisition?

**(a) Certain acquisitions by a member bank of securities issued by an affiliate are treated as a purchase of assets from an affiliate. A member bank's acquisition of a security issued by a company that was an affiliate of the member bank before the acquisition is treated as a purchase of assets from an affiliate, if:**

**(1) As a result of the transaction, the company becomes an operating subsidiary of the member bank; and**

**(2) The company has liabilities, or the member bank gives cash or any other consideration in exchange for the security.**

**(b) Valuation. (1) Initial valuation. A transaction described in paragraph (a) of this section must be valued initially at the greater of:**

**(i) The sum of:**

**(A) The total amount of consideration given by the member bank in exchange for the security; and**

**(B) The total liabilities of the company whose security has been acquired by the member bank, as of the time of the acquisition; or**

**(ii) The total value of all covered transactions (as computed under this part) acquired by the member bank as a result of the security acquisition.**

**(2) Ongoing valuation. The value of a transaction described in paragraph (a) of this section may be reduced after the initial transfer to reflect:**

**(i) Amortization or depreciation of the assets of the transferred company, to the extent that such reductions are consistent with GAAP; and**

**(ii) Sales of the assets of the transferred company.**

**(c) Valuation example. The parent holding company of a member bank contributes between 25 and 100 percent of the voting shares of a mortgage company to the member bank. The parent holding company retains no shares**

**of the mortgage company. The member bank gives no consideration in exchange for the transferred shares. The mortgage company has total assets of $300,000 and total liabilities of $100,000. The mortgage company's assets do not include any loans to an affiliate of the member bank or any other asset that would represent a separate covered transaction for the member bank upon consummation of the share transfer. As a result of the transaction, the mortgage company becomes an operating subsidiary of the member bank. The transaction is treated as a purchase of the assets of the mortgage company by the member bank from an affiliate under paragraph (a) of this section. The member bank initially must value the transaction at $100,000, the total amount of the liabilities of the mortgage company. Going forward, if the member bank pays off the liabilities, the member bank must continue to value the covered transaction at $100,000. If the member bank, however, sells $15,000 of the transferred assets of the mortgage company or if $15,000 of the transferred assets amortize, the member bank may value the covered transaction at $85,000.**

**(d) <u>Exemption for step transactions</u>. A transaction described in paragraph (a) of this section is exempt from the requirements of this regulation (other than the safety and soundness requirement of § 223.13 and the market terms requirement of § 223.51) if:**

**(1) The member bank acquires the securities issued by the transferred company within one business day (or such longer period, up to three months, as may be permitted by the member bank's appropriate Federal banking agency) after the company becomes an affiliate of the member bank;**

**(2) The member bank acquires all the securities of the transferred company that were transferred in connection with the transaction that made the company an affiliate of the member bank;**

**(3) The business and financial condition (including the asset quality and liabilities) of the transferred company does not materially change from the time the company becomes an affiliate of the member bank and the time the member bank acquires the securities issued by the company; and**

**(4) At or before the time that the transferred company becomes an affiliate of the member bank, the member bank notifies its appropriate Federal banking agency and the Board of its intent to acquire the company.**

**(e) <u>Example of step transaction</u>. A bank holding company acquires 100 percent of the shares of an unaffiliated leasing company. At that time, the subsidiary member bank of the holding company notifies its appropriate Federal banking agency and the Board of its intent to acquire the leasing company from its holding company. On the day after consummation of the acquisition, the holding company transfers all of the shares of the leasing company to the member bank. No material change in the business or financial condition of the leasing company occurs between the time of the holding company's acquisition and the member bank's acquisition. The leasing company has liabilities. The leasing company becomes an operating subsidiary of the member bank at the time of the transfer. This transfer by the holding company to the member bank, although deemed an asset purchase by the member bank from an affiliate under paragraph (a) of this section, would qualify for the exemption in paragraph (d) of this section.**

**§ 223.32 What rules apply to financial subsidiaries of a member bank?**

(a) <u>Exemption from the 10 percent limit for covered transactions between a member bank and a single financial subsidiary</u>. The 10 percent quantitative limit contained in § 223.11 does not apply with respect to covered transactions between a member bank and a financial subsidiary of the member bank. **The 20 percent quantitative limit contained in § 223.12 does apply to such transactions.**

**(b) <u>Valuation of purchases of or investments in the securities of a financial subsidiary</u>. (1) <u>General rule</u>. A member bank's purchase of or investment in a security issued by a financial subsidiary of the member bank must be valued at the greater of:**

**(i) The total amount of consideration given (including liabilities assumed) by the member bank in exchange for the security, reduced to reflect amortization of the security to the extent consistent with GAAP; and**

**(ii) The carrying value of the security (adjusted so as not to reflect the member bank's pro rata portion of any earnings retained or losses incurred by the financial subsidiary after the member bank's acquisition of the security).**

**(2) <u>Carrying value of an investment in a consolidated financial subsidiary</u>. If a financial subsidiary is consolidated with its parent member bank under GAAP, the carrying value of the member bank's investment in securities issued by the financial subsidiary shall be equal to the carrying value of the securities on parent-only financial statements of the member bank, determined in accordance with GAAP (adjusted so as not to reflect the member bank's pro rata portion of any earnings retained or losses incurred by the financial subsidiary after the member bank's acquisition of the securities).**

**(3) <u>Examples of the valuation of purchases of and investments in the securities of a financial subsidiary</u>. The following are examples of how a member bank must value its purchase of or investment in the securities of a financial subsidiary of the member bank. Each example involves a securities underwriter that becomes a financial subsidiary of the member bank after the transactions described below.**

**(i) <u>Initial valuation</u>. (A) <u>Direct acquisition by a member bank</u>. A member bank pays $500 to acquire 100 percent of the shares of a securities underwriter. The initial carrying value of the shares on the member bank's parent-only GAAP financial statements is $500. The member bank initially must value the investment at $500.**

**(B) <u>Contribution of a financial subsidiary to a member bank</u>. The parent holding company of a member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500, and immediately contributes the shares to the member bank. The member bank gives no consideration in exchange for the shares. The member bank initially must value the investment at the carrying value of the shares on the member bank's parent-only GAAP financial statements. Under GAAP, the member bank's initial carrying value of the shares would be $500.**

**(ii) <u>Carrying value not adjusted for earnings and losses of the financial subsidiary</u>. A member bank and its parent holding company engage in the transaction described in paragraph (b)(3)(i)(B) of this section, and the member bank initially values the investment at $500. In the following year, the securities underwriter earns $25 in profit, which is added to its retained earnings. The member bank's carrying value of the shares of the underwriter is not adjusted for purposes of this part, and the member bank must continue to value the investment at $500. If, however, the member bank contributes $100 of additional capital to the securities underwriter, the member bank must value the investment at $600.**

**(c) <u>Treatment of an affiliate's investments in, and extensions of credit to, a financial subsidiary of a member bank</u>.** (1) <u>Investments</u>. Any purchase of, or investment in, the securities of a financial subsidiary of a member bank by an affiliate of the member bank is treated as a purchase of or investment in such securities by the member bank.

**(2) Extensions of credit that are treated as regulatory capital of the financial subsidiary. Any extension of credit to a financial subsidiary of a member bank by an affiliate of the member bank is treated as an extension of credit by the member bank to the financial subsidiary if the extension of credit is treated as capital of the financial subsidiary under any Federal or State law, regulation, or interpretation applicable to the subsidiary.**

(3) Other extensions of credit. Any other extension of credit to a financial subsidiary of a member bank by an affiliate of the member bank will be treated as an extension of credit by the member bank to the financial subsidiary, if the Board determines, by regulation or order, that such treatment is necessary or appropriate to prevent evasions of the Federal Reserve Act or the Gramm-Leach-Bliley Act.

**§ 223.33 What rules apply to derivative transactions?**

**(a) Market terms requirement. Derivative transactions between a member bank and its affiliates (other than depository institutions) are subject to the market terms requirement of § 223.51.**

**(b) Policies and procedures. A member bank must establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from its derivative transactions with affiliates in a safe and sound manner. The policies and procedures must at a minimum provide for:**

**(1) Monitoring and controlling the credit exposure arising at any one time from the member bank's derivative transactions with each affiliate and all affiliates in the aggregate; and**

**(2) Ensuring that the member bank's derivative transactions with affiliates comply with the market terms requirement of § 223.51.**

**(c) <u>Credit derivatives</u>. A credit derivative between a member bank and a nonaffiliate in which the member bank provides credit protection to the nonaffiliate with respect to an obligation of an affiliate of the member bank is a guarantee by a member bank on behalf of an affiliate for purposes of this regulation. Such derivatives would include:**

**(1) An agreement under which the member bank, in exchange for a fee, agrees to compensate the nonaffiliate for any default of the underlying obligation of the affiliate; and**

**(2) An agreement under which the member bank, in exchange for payments based on the total return of the underlying obligation of the affiliate, agrees to pay the nonaffiliate a spread over funding costs plus any depreciation in the value of the underlying obligation of the affiliate.**

**Subpart E–Exemptions from the Provisions of Section 23A**

**§ 223.41 What covered transactions are exempt from the quantitative limits and collateral requirements?**

The following transactions are not subject to the quantitative limits of §§ 223.11 and 223.12 or the collateral requirements of § 223.14. The transactions are, however, subject to the safety and soundness requirement of § 223.13 and the prohibition on the purchase of a low-quality asset of § 223.15.

(a) <u>Parent institution/subsidiary institution transactions</u>. Transactions with a **depository institution** if the member bank controls 80 percent or more of the voting securities of the **depository institution** or the **depository institution** controls 80 percent or more of the voting securities of the member bank.

(b) <u>Transactions between a member bank and a depository institution owned by the same holding company</u>. Transactions with a **depository institution** if the same company controls 80 percent or more of the voting securities of the member bank and the **depository institution**.

(c) Certain loan purchases from an affiliated **depository institution**. Purchasing a loan on a nonrecourse basis from an affiliated **depository institution.**

**(d) Internal corporate reorganization transactions. Purchasing assets from an affiliate (including in connection with a transfer of securities issued by an affiliate to a member bank described in paragraph (a) of § 223.31), if:**

**(1) The asset purchase is part of an internal corporate reorganization of a holding company and involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate;**

**(2) The member bank provides its appropriate Federal banking agency and the Board with written notice of the transaction before consummation;**

**(3) The member bank's top-tier holding company commits to its appropriate Federal banking agency and the Board before consummation either:**

**(i) To make quarterly cash contributions to the member bank, for a two-year period following the member bank's purchase, equal to the book value plus any write-downs taken by the member bank, of any transferred assets that have become low-quality assets during the quarter; or**

**(ii) To repurchase, on a quarterly basis for a two-year period following the member bank's purchase, at a price equal to the book value plus any write-downs taken by the member bank, any transferred assets that have become low-quality assets during the quarter;**

**(4) The member bank's top-tier holding company complies with the commitment made under paragraph (d)(3) of this section;**

**(5) A majority of the member bank's directors reviews and approves the transaction before consummation;**

**(6) The value of the covered transaction (as computed under this part), when aggregated with the value of any other covered transactions (as**

**computed under this part) engaged in by the member bank under this exemption during the preceding 12 calendar months, represents less than 10 percent of the member bank's capital stock and surplus (or such higher amount, up to 25 percent of the member bank's capital stock and surplus, as may be permitted by the member bank's appropriate Federal banking agency after conducting a review of the member bank's financial condition and the quality of the assets transferred to the member bank); and**

**(7) The holding company and all its subsidiary member banks and other subsidiary depository institutions are well capitalized and well managed and would remain well capitalized upon consummation of the transaction.**

**§ 223.42 What covered transactions are exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition?**

The following transactions are not subject to the quantitative limits of §§ 223.11 and 223.12, the collateral requirements of § 223.14, or the prohibition on the purchase of a low-quality asset of § 223.15. The transactions are, however, subject to the safety and soundness requirement of § 223.13.

(a) <u>Making correspondent banking deposits</u>. Making a deposit in an affiliated **depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813))** or affiliated foreign bank **that represents an ongoing, working balance maintained** in the ordinary course of correspondent business.

(b) <u>Giving credit for uncollected items</u>. Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business.

(c) <u>Transactions secured by cash or U.S. government securities</u>.

(1) <u>In general</u>. Engaging in a credit transaction with an affiliate **to the extent that the transaction is and remains** secured by:

(i) Obligations of the United States or its agencies;

(ii) Obligations fully guaranteed by the United States or its agencies as to principal and interest; or

(iii) A segregated, earmarked deposit account with the member bank **that is for the sole purpose of securing credit transactions between the member bank and its affiliates and is identified as such.**

**(2) Example. A member bank makes a $100 non-amortizing term loan to an affiliate secured by U.S. Treasury securities with a market value of $50 and real estate with a market value of $75. The value of the covered transaction is $50. If the market value of the U.S. Treasury securities falls to $45 during the life of the loan, the value of the covered transaction would increase to $55.**

(d) Purchasing securities of a servicing affiliate. Purchasing a security issued by any company **engaged solely in** providing services described in section 4(c)(1) of the Bank Holding Company Act (12 U.S.C. 1843(c)(1)).

(e) Purchasing certain liquid assets. Purchasing an asset having a readily identifiable and publicly available market quotation and purchased at **or below the asset's current** market quotation. **An asset has a readily identifiable and publicly available market quotation if the asset's price is quoted routinely in a widely disseminated publication that is readily available to the general public.**

**(f) Purchasing certain marketable securities. Purchasing a security from a securities affiliate, if:**

**(1) The security has a "ready market," as defined in 17 CFR 240.15c3-1(c)(11)(i);**

**(2) The security is eligible for a State member bank to purchase directly, subject to the same terms and conditions that govern the investment activities of a State member bank, and the member bank records the transaction as a**

**purchase of a security for purposes of its Call Report, consistent with the requirements for a State member bank;**

**(3) The security is not a low-quality asset;**

**(4) The member bank does not purchase the security during an underwriting, or within 30 days of an underwriting, if an affiliate is an underwriter of the security, unless the security is purchased as part of an issue of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies;**

**(5) The security's price is quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks, provided that:**

**(i) The price paid by the member bank is at or below the current market quotation for the security; and**

**(ii) The size of the transaction executed by the member bank does not cast material doubt on the appropriateness of relying on the current market quotation for the security; and**

**(6) The member bank maintains, for a period of two years, records and supporting information that are sufficient to enable the appropriate Federal banking agency to ensure the member bank's compliance with the terms of this exemption.**

**(g) <u>Purchasing municipal securities</u>. Purchasing a municipal security from a securities affiliate if:**

**(1) The security is rated by a nationally recognized statistical rating organization or is part of an issue of securities that does not exceed $25 million;**

**(2) The security is eligible for purchase by a State member bank, subject to the same terms and conditions that govern the investment activities**

**of a State member bank, and the member bank records the transaction as a purchase of a security for purposes of its Call Report, consistent with the requirements for a State member bank; and**

**(3) (i) The security's price is quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks, provided that:**

**(A) The price paid by the member bank is at or below the current market quotation for the security; and**

**(B) The size of the transaction executed by the member bank does not cast material doubt on the appropriateness of relying on the current market quotation for the security; or**

**(ii) The price paid for the security can be verified by reference to two or more actual, current price quotes from unaffiliated broker-dealers on the exact security to be purchased or a security comparable to the security to be purchased, where:**

**(A) The price quotes obtained from the unaffiliated broker-dealers are based on a transaction similar in size to the transaction that is actually executed; and**

**(B) The price paid is no higher than the average of the price quotes; or**

**(iii) The price paid for the security can be verified by reference to the written summary provided by the syndicate manager to syndicate members that discloses the aggregate par values and prices of all bonds sold from the syndicate account, if the member bank:**

**(A) Purchases the municipal security during the underwriting period at a price that is at or below that indicated in the summary; and**

**(B) Obtains a copy of the summary from its securities affiliate and retains the summary for three years.**

(h) Purchasing an extension of credit subject to a repurchase agreement. Purchasing from an affiliate an extension of credit that was originated by the member bank and sold to the affiliate subject to a repurchase agreement or with recourse.

**(i) Asset purchases by a newly formed member bank. The purchase of an asset from an affiliate by a newly formed member bank, if the appropriate Federal banking agency for the member bank has approved the asset purchase in writing in connection with its review of the formation of the member bank.**

**(j) Transactions approved under the Bank Merger Act. Any merger or consolidation between a member bank and an affiliated depository institution or U.S. branch or agency of a foreign bank, or any acquisition of assets or assumption of deposit liabilities by a member bank from an affiliated depository institution or U.S. branch or agency of a foreign bank, if the transaction has been approved by the responsible Federal banking agency pursuant to the Bank Merger Act (12 U.S.C. 1828(c)).**

**(k) Purchasing an extension of credit from an affiliate. Purchasing from an affiliate, on a nonrecourse basis, an extension of credit, if:**

**(1) The extension of credit was originated by the affiliate;**

**(2) The member bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes or commits to make the extension of credit;**

**(3) The member bank commits to purchase the extension of credit before the affiliate makes or commits to make the extension of credit;**

**(4) The member bank does not make a blanket advance commitment to purchase extensions of credit from the affiliate; and**

**(5) The dollar amount of the extension of credit, when aggregated with the dollar amount of all other extensions of credit purchased from the affiliate during the preceding 12 calendar months by the member bank and its depository institution affiliates, does not represent more than 50 percent (or such lower percent as is imposed by the member bank's appropriate Federal banking agency) of the dollar amount of extensions of credit originated by the affiliate during the preceding 12 calendar months.**

**(l) <u>Intraday extensions of credit</u>. An intraday extension of credit to an affiliate, if the member bank:**

**(1) Establishes and maintains policies and procedures reasonably designed to manage the credit exposure arising from the member bank's intraday extensions of credit to affiliates in a safe and sound manner, including policies and procedures for:**

**(i) Monitoring and controlling the credit exposure arising at any one time from the member bank's intraday extensions of credit to each affiliate and all affiliates in the aggregate; and**

**(ii) Ensuring that any intraday extension of credit by the member bank to an affiliate complies with the market terms requirement of § 223.51;**

**(2) Has no reason to believe that the affiliate will have difficulty repaying the extension of credit in accordance with its terms; and**

**(3) Treats any such extension of credit (regardless of jurisdiction) that exists at the end of the member bank's business day in the United States, as a nonexempt covered transaction as of the end of the member bank's business day in the United States (assuming no other exemption applies to the transaction at such time).**

**(m) <u>Riskless principal transactions</u>. Purchasing a security from a securities affiliate of the member bank if:**

**(1) The member bank or the securities affiliate is acting exclusively as a riskless principal in the transaction; and**

**(2) The security purchased is not issued, underwritten, or sold as principal (other than as riskless principal) by any affiliate of the member bank.**

**§ 223.43 What are the standards under which the Board may grant additional exemptions from the requirements of section 23A?**

(a) The standards. The Board may, at its discretion, by regulation or order, exempt transactions or relationships from the requirements of section 23A **and subparts B, C, and D of this regulation** if it finds such exemptions to be in the public interest and consistent with the purposes of section 23A.

**(b) Procedure. A member bank may request an exemption from the requirements of section 23A and subpart B of this regulation by submitting a written request to the General Counsel of the Board.**

**Subpart F–General Provisions of Section 23B**

**§ 223.51 What is the market terms requirement of section 23B?**

A member bank may not engage in a transaction described in § 223.52 unless the transaction is:

(a) On terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the member bank, as those prevailing at the time for comparable transactions with or involving nonaffiliates; 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, nonaffiliates.

**§ 223.52 What transactions with affiliates or others must comply with section 23B's market terms requirement?**

(a) The market terms requirement of § 223.51 applies to the following transactions:

(1) Any covered transaction with an affiliate, unless the transaction is exempt under **paragraphs (a) through (c) of § 223.41 or paragraphs (a) through (e) or (h) through (j) of § 223.42;**

(2) The sale of a security or other asset to an affiliate, including an asset subject to an agreement to repurchase;

(3) The payment of money or the furnishing of a service to an affiliate under contract, lease, or otherwise;

(4) Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the member bank or to any other person; and

(5) Any transaction or series of transactions with a nonaffiliate, if an affiliate:

(i) Has a financial interest in the nonaffiliate; or

(ii) Is a participant in the transaction or series of transactions.

(b) For the purpose of this section, any transaction by a member bank with any person will be deemed to be a transaction with an affiliate of the member bank if any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate.

**§ 223.53 What asset purchases are prohibited by section 23B?**

(a) <u>Fiduciary purchases of assets from an affiliate</u>. A member bank may not purchase as fiduciary any security or other asset from any affiliate unless the purchase is permitted:

(1) Under the instrument creating the fiduciary relationship;

(2) By court order; or

(3) By law of the jurisdiction governing the fiduciary relationship.

(b) Purchase of a security underwritten by an affiliate. (1) A member bank, whether acting as principal or fiduciary, may not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of the member bank.

(2) Paragraph (b)(1) of this section does not apply if the purchase or acquisition of the security has been approved, before the security is initially offered for sale to the public, by a majority of the directors of the member bank based on a determination that the purchase is a sound investment for the member bank, **or for the person on whose behalf the member bank is acting as fiduciary, as the case may be,** irrespective of the fact that an affiliate of the member bank is a principal underwriter of the security.

**(3) The approval requirement of paragraph (b)(2) of this section may be met if:**

**(i) A majority of the directors of the member bank approves standards for the member bank's acquisitions of securities described in paragraph (b)(1) of this section, based on the determination set forth in paragraph (b)(2) of this section;**

**(ii) Each acquisition described in paragraph (b)(1) of this section meets the standards; and**

**(iii) A majority of the directors of the member bank periodically reviews acquisitions described in paragraph (b)(1) of this section to ensure that they meet the standards and periodically reviews the standards to ensure that they continue to meet the criterion set forth in paragraph (b)(2) of this section**.

**(4) A U.S. branch, agency, or commercial lending company of a foreign bank may comply with paragraphs (b)(2) and (b)(3) of this section by obtaining the approvals and reviews required by paragraphs (b)(2) and (b)(3) from either:**

**(i) A majority of the directors of the foreign bank; or**

**(ii) A majority of the senior executive officers of the foreign bank.**

(c) Special definitions.

For purposes of this section:

(1) "Principal underwriter" means any underwriter who, in connection with a primary distribution of securities:

(i) Is in privity of contract with the issuer or an affiliated person of the issuer;

(ii) Acting alone or in concert with one or more other persons, initiates or directs the formation of an underwriting syndicate; or

(iii) Is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

(2) "Security" has the same meaning as in section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)).

**§ 223.54 What advertisements and statements are prohibited by section 23B?**

(a) In general. A member bank and its affiliates 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.

**(b) Guarantees, acceptances, letters of credit, and cross-affiliate netting arrangements subject to section 23A. Paragraph (a) of this section does not prohibit a member bank from:**

**(1) Issuing a guarantee, acceptance, or letter of credit on behalf of an affiliate, confirming a letter of credit issued by an affiliate, or entering into a cross-affiliate netting arrangement, to the extent such transaction satisfies the quantitative limits of §§ 223.11 and 223.12 and the collateral requirements of § 223.14, and is otherwise permitted under this regulation; or**

**(2) Making reference to such a guarantee, acceptance, letter of credit, or cross-affiliate netting arrangement if otherwise required by law.**

**§ 223.55 What are the standards under which the Board may grant exemptions from the requirements of section 23B?**

The Board may prescribe regulations to exempt transactions or relationships from the requirements of section 23B **and subpart F of this regulation** if it finds such exemptions to be in the public interest and consistent with the purposes of section 23B.

**Subpart G–Application of Sections 23A and 23B to U.S. Branches and Agencies of Foreign Banks**

**§ 223.61 How do sections 23A and 23B apply to U.S. branches and agencies of foreign banks?**

**(a) <u>Applicability of sections 23A and 23B to foreign banks engaged in underwriting insurance, underwriting or dealing in securities, merchant banking, or insurance company investment in the United States</u>. Except as provided in this subpart, sections 23A and 23B of the Federal Reserve Act and the provisions of this regulation apply to each U.S. branch, agency, or commercial lending company of a foreign bank in the same manner and to the same extent as if the branch, agency, or commercial lending company were a member bank.**

**(b) <u>Affiliate defined</u>. For purposes of this subpart, any company that would be an affiliate of a U.S. branch, agency, or commercial lending company of a foreign bank if such branch, agency, or commercial lending company were a member bank is an affiliate of the branch, agency, or commercial lending company if the company also is:**

**(1) Directly engaged in the United States in any of the following activities:**

**(i) Insurance underwriting pursuant to section 4(k)(4)(B) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(B));**

**(ii) Securities underwriting, dealing, or market making pursuant to section 4(k)(4)(E) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(E));**

**(iii) Merchant banking activities pursuant to section 4(k)(4)(H) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(H)) (but only to the extent that the proceeds of the transaction are used for the purpose of funding the affiliate's merchant banking activities);**

**(iv) Insurance company investment activities pursuant to section 4(k)(4)(I) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(I)); or**

**(v) Any other activity designated by the Board;**

**(2) A portfolio company (as defined in the merchant banking subpart of Regulation Y (12 CFR 225.177(c))) controlled by the foreign bank or an affiliate of the foreign bank or a company that would be an affiliate of the branch, agency, or commercial lending company of the foreign bank under paragraph (a)(9) of § 223.2 if such branch, agency, or commercial lending company were a member bank; or**

**(3) A subsidiary of an affiliate described in paragraph (b)(1) or (2) of this section.**

**(c) <u>Capital stock and surplus</u>. For purposes of this subpart, the "<u>capital stock and surplus</u>" of a U.S. branch, agency, or commercial lending company of a foreign bank will be determined by reference to the capital of the foreign bank as calculated under its home country capital standards.**

**Subpart H–Miscellaneous Interpretations**

**§ 223.71 How do sections 23A and 23B apply to transactions in which a member bank purchases from one affiliate an asset relating to another affiliate?**

**(a) In general. In some situations in which a member bank purchases an asset from an affiliate, the asset purchase qualifies for an exemption under this regulation, but the member bank's resulting ownership of the purchased asset also represents another covered transaction (which may or may not qualify for an exemption under this regulation). In these situations, the transaction engaged in by the member bank represents two separate covered transactions, each of which would need an exemption from section 23A in order for the entire transaction to be exempt. Although an asset purchase exemption may suffice to exempt the member bank's asset purchase from the first affiliate, the asset purchase exemption does not exempt the member bank's resulting covered transaction with the second affiliate. The exemptions subject to this interpretation include §§ 223.31(e), 223.41(a) through (d), and 223.42(e), (f), (i), (j), (k), and (m).**

**(b) Examples.**

**(1) The (d)(6) exemption. A member bank purchases from Affiliate A securities issued by Affiliate B in a purchase that qualifies for the (d)(6) exemption in section 23A. The member bank's asset purchase from Affiliate A would be an exempt covered transaction under § 223.42(e); but the member bank also would have acquired an investment in securities issued by Affiliate B, which would be a covered transaction between the member bank and Affiliate B under § 223.3(h)(2) that does not qualify for the (d)(6) exemption. The (d)(6) exemption, by its terms, only exempts asset purchases by a member bank from an affiliate; hence, the (d)(6) exemption cannot**

**exempt a member bank's investment in securities issued by an affiliate (even if the securities would qualify for the (d)(6) exemption).**

**(2) <u>The sister-bank exemption</u>. A member bank purchases from Sister-Bank Affiliate A a loan to Affiliate B in a purchase that qualifies for the sister-bank exemption in section 23A. The member bank's asset purchase from Sister-Bank Affiliate A would be an exempt covered transaction under § 223.41(b); but the member bank also would have acquired an extension of credit to Affiliate B, which would be a covered transaction between the member bank and Affiliate B under § 223.3(h)(1) that does not qualify for the sister-bank exemption. The sister-bank exemption, by its terms, only exempts transactions by a member bank with a sister-bank affiliate; hence, the sister-bank exemption cannot exempt a member bank's extension of credit to an affiliate that is not a sister bank (even if the extension of credit was purchased from a sister bank).**

By order of the Board of Governors of the Federal Reserve System,
_________ __, 2002.

Jennifer J. Johnson,
Secretary of the Board.
BILLING CODE 6210-01-P

## APPENDIX C

**FEDERAL RESERVE SYSTEM**

**12 CFR Part 250**

**[Miscellaneous Interpretations]**

**Transactions Between Member Banks and Their Affiliates**

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Final rule.

**SUMMARY:** Sections 23A and 23B of the Federal Reserve Act restrict the ability of a member bank to engage in certain transactions with an affiliate. Since its initial passage in 1933, the Board and its staff have issued numerous formal and informal interpretations of section 23A. On _________, 2002, the Board adopted a new Regulation W, which implements sections 23A and 23B and incorporates most of these interpretations. Accordingly, the Board is rescinding most of its formal interpretations and removing these interpretations, as well as most staff opinions, from the Federal Reserve Regulatory Service. With the adoption of Regulation W, most of the Board's previous interpretations are outdated or unnecessary, and the Board believes that reliance on the new Regulation W will eliminate confusion and simplify compliance with sections 23A and 23B.

**EFFECTIVE DATE:** April 1, 2003

**FOR FURTHER INFORMATION CONTACT:** Pamela G. Nardolilli, Senior Counsel (202/452-3289), or Mark E. Van Der Weide, Counsel (202/452-2263), Legal Division; Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551.

**SUPPLEMENTARY INFORMATION:**

Sections 23A and 23B of the Federal Reserve Act are two of the most important statutory protections against a bank suffering losses because of its transactions with affiliates and, correspondingly, are two of the most effective means of limiting the ability of a bank to transfer to its affiliates the subsidy arising from a bank's access to the Federal safety net. Although sections 23A and 23B each explicitly grant the Board broad authority to issue regulations to administer these sections,[1] the Board never issued a regulation fully implementing either section. Instead, banks seeking guidance on how to comply with sections 23A and 23B have relied on a series of Board interpretations and informal staff guidance. Some of these interpretations are codified in Part 250 of Title 12 of the Code of Federal Regulations. Many of the staff interpretations are publicly available, and the

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[1] 12 U.S.C. 371c(f), 371c-1(e).

summaries of the interpretations can be found in the Board's loose-leaf service, the Federal Reserve Regulatory Service.

On ______, 2002, the Board adopted Regulation W, which comprehensively implements sections 23A and 23B of the Federal Reserve Act. In order to avoid confusion and simplify compliance with sections 23A and 23B, the Board is deleting the section 23A interpretations that are codified in Part 250 of title 12 of the Code of Federal Regulations. In addition, the Board also is deleting most of the summaries of staff interpretations of section 23A that are published in the Federal Reserve Regulatory Service.

Below is a chart of the interpretations of sections 23A and 23B found in the Federal Reserve Regulatory Service along with an indication of whether each summary will be retained in the Federal Reserve Regulatory Service or removed. For those summaries that will be removed, the chart identifies the provision of Regulation W or an appropriate statute that renders the summary unnecessary or inconsistent with current law. There are a few existing interpretations that the Board believes would provide helpful guidance to users of Regulation W, but which are too fact-specific to codify; the summaries of these interpretations will remain in the Federal Reserve Regulatory Service. All new Board interpretations of sections 23A and 23B will be codified under Part 223 instead of the Miscellaneous Interpretations found in Part 250 and will be available on the Board's public website, www.federalreserveboard.gov. Persons desiring older written interpretations will be able to obtain them by filing a request pursuant to the Freedom of Information Act.

## DELETIONS FROM FEDERAL RESERVE REGULATORY SERVICE

### Board Interpretations

| FRRS Number | Subject | **12 CFR Reference** |
|---|---|---|
| 3-1118<br>12 CFR 250.242 | Definition of Capital Stock and Surplus | § 223.3(d) |
| 3-1120<br>1934 Fed. Res. Bull. 391 | Collateral-Paper Eligible for Rediscount or Purchase by Federal Reserve Banks | § 223.14(b)(1) |
| 3-1121<br>1935 Fed. Res. Bull. 395 | Collateral-Stock | § 223.14(b)(1)(iv) |
| 3-1125<br>1936 Fed. Res. Bull. 324 | Exemptions-Indebtedness for Unpaid Balances Due on Purchased Assets | No exemption available |
| 3-1126<br>S-285, 10/24/41 | Exemptions-Relationships Arising Out of Bona Fide Debt Previously Contracted | § 223.2(b)(5) |
| 3-1127<br>12 CFR 250.240 | Exemptions-Loan to Bank Operations Subsidiary | §§ 223.2(b)(1) & (2) |
| 3-1128<br>12 CFR 250.241 | Exemptions-Transactions Subject to Review Under the Bank Merger Act | § 223.42(j) |
| 3-1128.1<br>12 CFR 250.245 | Exemptions-Loans and Extensions of Credit by Member Bank to Third Party | § 223.16(c)(3) |
| 3-1128.2<br>12 CFR 250.246 | Exemptions-Purchase of Security by Insured Depository Institution from an Affiliate | § 223.42(e) |
| 3-1130<br>1934 Fed. Res. Bull. 391 | Extension of Credit-Loan on Note Bearing Endorsement by Affiliate | Retain |
| 3-1131<br>1951 Fed. Res. Bull. 960 | Extension of Credit-Purchase of Affiliate's Notes | § 223.3(o)(4) |

| FRRS Number | Subject | **12 CFR Reference** |
|---|---|---|
| 3-1132<br>12 CFR 250.160(b) | Extension of Credit-Federal Funds Transaction | § 223.3(o) |
| 3-1133<br>12 CFR 250.250 | Extension of Credit-Purchase of Mortgage Note or Participation from Nonbank Affiliates | § 223.42(k) |
| 3-1135<br>1933 Fed. Res. Bull. 501 | Loans & Investments Made Before June 16, 1933 | See Preamble For Grandfathering |
| 3-1136<br>1934 Fed. Res. Bull. 391 | Limitations on Amount-Loans Secured by Paper Eligible for Rediscount by Federal Reserve Bank | § 223.14(b)(1)(C) |
| 3-1137<br>12 CFR 250.247 | Market Terms Requirement-Derivatives | § 223.33 |
| 3-1137.1<br>12 CFR 250.248 | Market Terms Requirement-Intraday Extensions of Credit by Insured Depository Institutions to Their Affiliates | § 223.42(l) |
| 3-1140 | Affiliates to Which Applicable-Cotrustee or Coexecutor of Corporation | § 223.2(b) |
| 3-1141 | Affiliates to Which Applicable | Retain |
| 3-1142 | Affiliates to Which Applicable-Small Business Subsidiary of Bank Holding Company | § 223.2(a)(2) |
| 3-1143 | Affiliate to Which Applicable-Joint Venture in Which Subsidiary Has 50% Interest | § 223.2(b)(1)(iii) |
| 3-1144 | Affiliates to Which Applicable-Corporation with Stock Held as Collateral | § 223.2(p)(1)(ii) |
| 3-1145 | Affiliates to Which Applicable-Corporation Owned by Affiliate Edge Corporation | § 223.2(p)(1)(ii) |
| 3-1146 | Affiliates to Which Applicable-Trust | Retain |
| 3-1146.1 | Affiliates to Which Applicable-Foreign Affiliate of Domestic Bank Holding Company | § 223.2(a)(2) |
| 3-1146.2 | Affiliates to Which Applicable-Less Than 25 Percent Control | § 223.2(a)(3) |
| 3-1146.3 | Affiliates to Which Applicable-Agricultural Credit Corporation | § 223.2(b)(1)(iii) |
| 3-1146.4 | Affiliates to Which Applicable-Bank Subsidiaries of Bank Holding Company | § 223.2(b)(1) |
| 3-1146.5 | Affiliates to Which Applicable-Purchaser of Subsidiary Banks | § 223.16 |

| FRRS Number | Subject | **12 CFR Reference** |
|---|---|---|
| 3-1146.6 | Affiliates to Which Applicable-Common Shareholders | Retain |
| 3-1146.61 | Affiliates to Which Applicable-Partnership & Association | Retain |
| 3-1146.7 | Affiliates to Which Applicable-Foreign Exchange Fund | Retain |
| 3-1150 | Bank-Savings Loan | 12 U.S.C. § 1468 |
| 3-1151 | Bank-Bank Whose Deposits Are Insured by the FDIC | 12 U.S.C. § 1828(j) |
| 3-1152 | Bank-Foreign Bank | 12 U.S.C. § 371c(b)(5) & § 223.18 |
| 3-1152.1 | Bank-Domestic Branch of a Foreign Bank | 12 U.S.C. § 371c(b)(5) & § 223.3(k) |
| 3-1152.2 | Bank-National Bank Subsidiary | 12 U.S.C. § 371c(b)(5) |
| 3-1155 | Collateral-Automobile Rental Contracts | § 223.14(b)(1)(iv) |
| 3-1156 | Collateral-Stock | § 223.24 |
| 3-1157 | Collateral-“Secured by” | § 223.14 |
| 3-1158 | Collateral-Stock in Wholly Owned Subsidiary | § 223.14 |
| 3-1160 | Collateral-FHA Mortgages | § 223.3(y) |
| 3-1161 | Collateral-U.S. Government Securities | § 223.14 |
| 3-1162 | Collateral-Stock Valuation | Retain |
| 3-1163 | Collateral-Stock Valuation | Retain |
| 3-1164 | Collateral-Stock Valuation | Retain |
| 3-1164.1 | Collateral-Stock of a Subsidiary Bank | § 223.14(c)(2) |
| 3-1164.2 | Collateral-Real Estate | § 223.14(b)(l)(iv) |
| 3-1164.3 | Collateral-Mortgage Servicing Rights | § 223.14(c)(4) |
| 3-1167 | Covered Transactions-Purchase of Affiliate’s Securities | § 223.3(h)(2) |
| 3-1167.1 | Covered Transactions-Purchase of Assets | Retain |
| 3-1167.2 | Covered Transactions-Purchase of Assets | § 223.42(k) |
| 3-1167.3 | Covered Transactions-Acceptance of Securities | Retain |
| 3-1167.4 | Covered Transactions-Issuance of Guarantee | Retain |
| 3-1167.5 | Covered Transactions-Purchase of Leases | § 223.42(k) & Subpart F |
| 3-1170 | Exemptions-Indebtedness for Unpaid Balances Due on Purchased Assets | § 223.3(h) |
| 3-1171 | Exemptions-Corporation Holding | § 223.2(b)(2) |

| FRRS Number | Subject | **12 CFR Reference** |
|---|---|---|
| | Premises of Bank | |
| 3-1172 | Exemptions-Investment in Agricultural Credit Corporation | § 223.2 |
| 3-1173 | Exemptions-Sale of Assets on Credit | § 223.3(h)(1) |
| 3-1174 | Exemptions-Trust | § 223.2 |
| 3-1175 | Exemptions-Loans to Subsidiary Bank Premises | § 223.2(b)(2) |
| 3-1176 | Exemptions-Corporation Holding Premises of Bank | § 223.2(b)(2) |
| 3-1177 | Exemptions-Bank Operations Subsidiary | § 223.2(b)(1) |
| 3-1177.1 | Exemptions-Bank Controlled by Same Company | §§ 223.41(b) & 223.3(k) & (v) |
| 3-1177.2 | Exemptions-Bank Premises Subsidiary | § 223.2(a)(3) & (b)(2) |
| 3-1177.3 | Exemptions-Privately Issued Collateralized Mortgage Obligations | Retain |
| 3-1177.4 | Exemptions-Bank Controlled by Same Company That Is Not Bank Holding Company | § 223.41(b) |
| 3-1180 | Extension of Credit-Nonrecourse Acquisition of Promissory Note | § 223.3(o)(4) |
| 3-1181 | Extension of Credit-Transaction with Bank Holding Company | §§ 223.3(o) & 223.42(h) |
| 3-1182 | Extension of Credit-Guaranteed Debt of Holding Company | § 225.3(o) |
| 3-1183 | Extension of Credit-Participation in Assets Pool | Delete |
| 3-1184 | Extension of Credit-Purchase of Mortgage Note or Participation from Nonbank Affiliate | § 223.42(k) |
| 3-1185 | Extension of Credit-GNMA Certificate of Guarantee | Retain |
| 3-1186 | Extension of Credit-Paid Letter of Credit | § 223.3(o) |
| 3-1187 | Extension of Credit-Equipment Lease Agreement | Retain |
| 3-1188 | Extension of Credit-Participation in Mortgage Loan Pool | § 223.42(k) |
| 3-1189 | Extension of Credit-Finance Company Loan Participation | § 223.42(k) |
| 3-1189.1 | Extension of Credit-Transactions Involving Funding, Letters of Credit & Bankers Acceptance | §§ 223.3(h)(1) & 223.3(h)(5) |

| FRRS Number | Subject | **12 CFR Reference** |
|---|---|---|
| 3-1189.2 | Extension of Credit-Contingency, Negotiating or Accepting Letters of Credit | § 223.3(h) |
| 3-1195 | Limitations on Amount-Loans & Investments Made Before June 16, 1933 | See Preamble For Grandfathering |
| 3-1196 | Limitations on Amount-Loan Secured by Paper Eligible for Rediscount or Purchase by Federal Reserve Bank | § 223.14(b)(i)(C) |
| 3-1197 | Limitations on Amount-Capital Stock | § 223.3(h)(2) |
| 3-1198 | Limitations on Amount-Stockholder Ownership & Capital Expenditures | §§ 223.3(h) & 223.7(c) |
| 3-1199 | Limitations on Amount-Valuation of Transactions | § 223.24(b) |
| 3-1199.5 | Low-Quality Asset-Open-End Credit Card Account | Retain |
| | Low-Quality Assets-Renewal of a Loan | § 223.15(b) |

**Regulatory Flexibility Act**

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603(a)), the Board is not required to publish a regulatory flexibility analysis with this rulemaking.

**Administrative Procedure Act**

Pursuant to 5 U.S.C. 553, the Board is issuing this deletion of the existing section 23A interpretations as a final rule. Most of the interpretations in question are staff opinions, which were not subject to public comment pursuant to 5 U.S.C. 553(b)(2)(A). The deletion of the Board interpretations from the Code of Federal Regulations is part of the implementation of Regulation W, which the Board issued for public notice and comment on May 11, 2001, and thus further public comment on the deletions is unnecessary. A review of the public comments on Regulation W can be found in the preamble to Regulation W, 67 Federal Register ___ (2002).

**Paperwork Reduction Act**

The Board has determined that the removal of the interpretations from the Code of Federal Regulations will not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq*.).

**List of Subjects in 12 CFR Part 250**

Federal Reserve System.

For reasons set out in the preamble, the Board amends 12 CFR part 250 as follows:

**PART 250–MISCELLANEOUS INTERPRETATIONS**

1. The authority citation for part 250 is revised to read as follows:

**Authority:** 12 U.S.C. 78, 248(i), 371c(f) and 371c-1(e).

2. In § 250.160, remove paragraph (b).

3. Remove § 250.240.

4. Remove § 250.241.

5. Remove § 250.242.

6. Remove § 250.243.

7. Remove § 250.244.

8. Remove § 250.245.

9. Remove § 250.246.

10. Remove § 250.247.

11. Remove § 250.248.

12. Remove § 250.250.

By order of the Board of Governors of the Federal Reserve System, _[Date]____.

Jennifer J. Johnson
Secretary of the Board.
Billing Code 6210-01-P

**APPENDIX D**

**FEDERAL RESERVE SYSTEM**

**12 CFR Part 223**

**[Regulation W; Docket No. R- _____]**

**Transactions Between Member Banks and their Affiliates**

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Proposed rule.

**SUMMARY:** The Board of Governors of the Federal Reserve System proposes to amend an exemption in Regulation W that permits a member bank to exclude the purchase of an extension of credit from an affiliate from the quantitative limits imposed by section 23A of the Federal Reserve Act if certain criteria are met. The proposed amendment would limit a member bank's ability to buy an extension of credit from an affiliate under the exemption to 100 percent of the capital stock and surplus of the member bank.

**DATES:** Submit comments on or before [Insert date 30 days after the date of publication in the Federal Register].

**ADDRESSES:** Comments should refer to docket number R-____ and should be sent to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551 or mailed electronically to regs.comments@federalreserve.gov. Comments addressed to Ms. Johnson also may be delivered between 8:45 a.m. and 5:15 p.m. to the Board's mail facility in the west courtyard of the Eccles Building, located on 21st Street between Constitution Avenue and C Street, N.W. Members of the public may inspect comments in accordance with the Board's Rules Regarding the Availability of Information (12 CFR part 261) in Room MP-500 of the Martin Building on weekdays between 9:00 a.m. and 5:00 p.m.

**FOR FURTHER INFORMATION CONTACT:** Pamela G. Nardolilli, Senior Counsel (202/452-3289), or Mark E. Van Der Weide, Counsel (202/452-2263), Legal Division; for users of Telecommunications Devices for the Deaf (TTD) only, contact 202/263-4869.

**SUPPLEMENTARY INFORMATION:**

**Background**

Section 23A is designed to protect banks from misuse in financial transactions with their affiliates that the statute presumes may result from affiliation. Section 23A attempts to accomplish this goal by imposing safeguards on all "covered transactions" between a bank and its affiliates; this includes limiting all covered transactions by a bank with any single affiliate to no more than 10 percent of the bank's capital stock and surplus, and limiting a bank's covered transactions with all affiliates to 20 percent of the bank's capital stock and surplus.

In 1979, the Board issued a formal interpretation that exempted from section 23A a bank's purchase, on a nonrecourse basis, of a mortgage note or participation therein from a mortgage banking affiliate, provided that the bank's commitment to purchase was (i) obtained by the affiliate within the context of each proposed loan, (ii) obtained prior to the affiliate's commitment to make each loan, and (iii) based upon the bank's independent evaluation of the creditworthiness of each mortgagor (the "Purchase Exemption").[1] Although this interpretation did not impose a strict dollar limit on the amount of an affiliate's mortgage loans that a bank could purchase under the 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 Purchase Exemption extensively to fund their lending affiliates. In those cases, banks were providing all or nearly all of their affiliates' funding. In response, staff indicated in an interpretive letter that the Purchase Exemption was not available if the dollar amount of the bank's loan purchases from the affiliate

[1] This exemption was codified at 12 CFR 250.250 (2002).

represented more than 50 percent of the total dollar amount of loans originated by the affiliate. 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.

In 2001, the Board reviewed a proposal where a leasing company proposed to charter a bank for the primary purpose of purchasing loans or leases from the leasing company.[2] The Board was concerned that, under the proposal, the new bank's credit underwriting process could be compromised as result of the complete dependence of the bank on the affiliate for asset growth. The Board conditioned its approval of the proposal on the bank limiting its purchases of leases or loans from an affiliate to no more than 50 percent of the bank's credit portfolio.

Concurrently with the issuance of this proposed rule, the Board is adopting final Regulation W, which incorporates the Purchase Exemption at

[2] Amplicon Inc., 87 Federal Reserve Bulletin 421 (2001).

12 CFR 223.42(k) and formally expands the exemption to cover the purchase of any of type of extension of credit from an affiliate.

The Purchase Exemption in Regulation W also retains the limitations previously imposed by staff that prevent a bank from using the Purchase Exemption to purchase more than 50 percent of the loans originated by any affiliate. When the Board proposed Regulation W, the preamble of the regulation asked for comment on whether the rule should include a quantitative condition to the Purchase Exemption based on the size of the purchasing bank.[3] The Board, however, did not propose a specific bank limit at that time. Eleven commenters objected to such a condition and argued that case-by-case review is a better approach to handling situations where a large portion of a bank's assets is loans purchased from an affiliate. These commenters believed that the remaining conditions of the Purchase Exemption should suffice to prevent abuse of the bank. One commenter, on the other hand, recommended that the rule include a 50 percent limit based on the assets of the bank.

In light of the comments and the fact that the Board did not set forth a specific limit based on the bank's size in proposed Regulation W, the Board now proposes to amend Regulation W to impose a limitation on the

[3] 66 FR 24186, 24199-00, May 11, 2001.

Purchase Exemption based on the capital stock and surplus of the bank. Specifically, the Board is requesting comment on a condition that would limit the amount of extensions of credit that a bank could purchase from an affiliate under the Purchase Exemption to 100 percent of the bank's capital stock and surplus. All other restrictions imposed by the Purchase Exemption would still apply. Although those restrictions include a requirement that the bank conduct an independent credit review prior to purchasing assets under the Purchase Exemption, sections 23A and 23B were enacted in recognition that the bank might relax its independent judgment when making credit decisions involving an affiliate. The Board believes that the 100 percent limit will guard against a bank acquiring an excessive concentration of assets under the Purchase Exemption, but will still provide the bank with the flexibility to purchase assets from an affiliate, within prudential limitations, in an amount well in excess of the statute's 10 and 20 percent quantitative limits.

**Regulatory Flexibility Act**

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603(a)) the Board must publish an initial regulatory flexibility analysis with this proposed regulation. As discussed above, the purpose of the rule is to limit the concentration of assets held by a bank that are originated by an affiliate and to reduce pressure on the bank to make inappropriate credit decisions. The Board does not collect data on the number of institutions that take advantage of the current exemption. There are approximately 3,300 banks below $100 million in assets, but the Board does not believe that a significant number of these institutions engage in Purchase Exemption transactions because most banks of that size do not have affiliates engaged in credit-extending activities. The requirements of the proposed rule would be the same for all depository institutions regardless of their size. The Board knows of no other regulations that overlap, conflict with, or duplicate the proposed rule. The Board solicits comment on the likely impact the proposed rule would have on depository institutions, including small depository institutions. The proposed rule contains no reporting requirement.

**Paperwork Reduction Act**

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board has reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget. The proposed rule contains no new collections of information and proposes no substantive changes to existing collections of information pursuant to the Paperwork Reduction Act.

**List of Subjects in 12 CFR Part 223**

Banks, Banking, Affiliates, Federal Reserve System.

For reasons stated in the preamble, the Board of Governors proposes to amend § 223.42 by adding a new paragraph (k)(6) to read as set forth below:

**Part 223 – Transactions Between Member Banks and Their Affiliates (Regulation W)**

1. The authority citation for Part 223 continues to read as follows:

   Authority: 12 U.S.C. 371c(b)(1)(E), (b)(2)(A), and (f), 371c-1(e), 1828(j), and 1468(a).

2. In § 223.42, add the following paragraph.

   * * * * *

   (k)(6) The dollar amount of the extension of credit, when aggregated with the dollar amount of all other extensions of credit purchased by the member bank from affiliates under this exemption and currently owned by the member bank, does not represent more than 100 percent (or such lower percent as is imposed by the member bank's appropriate Federal banking agency) of the capital stock and surplus of the member bank.

Board of Governors of the Federal Reserve System, ____________,

2002.

Jennifer J. Johnson,
Secretary of the Board.
[FR Doc. 02-0000 Filed 00-00-02; 8:45 am]
**Billling Code 6210-01-S**