6000—BANK REGULATIONS

The 6000 series of sections provide information on selected regulations that pertain to safety and soundness examinations of state member banks that are not already addressed in other parts of the manual. These sections summarize and explain the rules, as amended, but are not substitutes for the rules themselves. Refer to the *Code of Federal Regulations* (CFR) for more information on the Federal Reserve's regulations.

It is important for a federally insured depository institution[1] (bank) to control and limit the risk exposures posed to it by another domestic bank (whether or not that institution is an insured depository institution) or foreign bank with which it does business (referred to as a *correspondent*). These exposures may include all extensions of credit to a correspondent; deposits or reverse repurchase agreements with a correspondent; guarantees, acceptances, or standby letters of credit on behalf of a correspondent; purchases or acceptance as collateral of correspondent-issued securities; and all similar transactions. A bank needs to develop internal procedures to evaluate and control the risk exposures to the bank from its correspondents. Such procedures would help prevent a situation whereby the failure of a single correspondent could trigger the failure of a federally insured depository institution having claims on the failed correspondent. (See SR-93-36.)

A bank's principal sources of exposure to its correspondent tend to arise from two types of activity. First, banks may become exposed when obtaining services from (such as check-collection services), or providing services to, their correspondents. Second, exposure may arise when banks engage in transactions with correspondents in the financial markets. Each type of exposure has its own characteristics and its own risks.

Correspondent banking services are the primary source of interbank exposure for the majority of banks, particularly small and medium-sized banks. In connection with check-collection services and other trade- or payment-related correspondent services, banks often maintain balances with their correspondents in order to settle transactions and compensate the correspondents for the services provided. These balances give rise to exposure to the correspondents. Although correspondent services are in some cases provided on a fee basis, many correspondents may prefer compensating-balance arrangements, as these balances provide the correspondents with a stable source of funding. Also, some banks may prefer to pay for services with "soft charges" in the form of balances instead of "hard charges" in the form of fees.

Exposure to a correspondent may be significant, particularly when a bank uses one correspondent for all of its check collections and other payment services; loans excess reserve account balances (federal, or fed, funds) to the correspondent,[2] or engages in other banking transactions with correspondents.[3] This exposure may increase when interest rates fall, as higher levels of compensating balances may be required to provide adequate compensation to the correspondent.

Money-center banks and large regional banks may have significant exposure to correspondents[4] through their activities in interbank markets, such as the securities, swap, and foreign-exchange markets. Interbank transactions that call for performance in the future (such as swaps, foreign-exchange contracts, and over-the-counter options) give rise to exposure to the correspondents that act as counterparties[5] in such transactions. In addition to credit risk, such transactions may involve interest-rate risk,

1. A federally insured depository institution refers to a bank, as defined in section 3 of the Federal Deposit Insurance Act (12 USC 1813), and includes a federally insured national bank, state bank, District bank, or savings association, and a federally insured branch of a foreign bank.

2. In the fed funds market, a loan of fed funds is often referred to as a sale. Borrowing of fed funds is referred to as a purchase.

3. Although a bank's primary correspondent often will borrow (purchase) fed funds as principal directly from the bank, a correspondent may act as agent to place the funds with another institution. In such agency arrangements, a bank may provide its correspondent with a preapproved list of institutions with which the correspondent may place the funds. When a correspondent is acting as the bank's agent in placing fed funds, the bank's exposure would be to the ultimate purchaser of the funds, not to the correspondent placing the funds on its behalf.

Generally, fed funds loans are unsecured. A bank may also provide funds to a correspondent through transactions known as *reverse repurchase agreements*, in which the bank provides funds to the correspondent by buying an asset, generally a government security. The correspondent agrees that it will repurchase the asset from the bank at the expiration of a set period, generally overnight, at a repurchase price calculated to compensate the bank for the use of its funds. Unlike fed funds loans, these transactions are essentially secured transactions.

4. Although the depository institutions that are parties to transactions in the interbank markets discussed above generally are referred to as *counterparties*, the term *correspondent* is used in this discussion to denote any domestic depository institution or a foreign bank to which a bank is exposed. The term *correspondent* does not include a commonly controlled correspondent, as defined in section 206.2(b) of Regulation F.

5. In other banking transactions, such as foreign-exchange, money market, and other permissible transactions, activities, or contractual arrangements, the other party to the transaction is referred to as the counterparty rather than as the correspondent.

foreign-exchange risk, and settlement risk. Settlement risk is the risk that a counterparty will fail to make a payment or delivery in a timely manner. Settlement risk may arise from unsecured transactions in the government securities, foreign-exchange, or other markets, and it may result from operational, liquidity, or credit problems.

Lending limits prohibit national banks from lending amounts equal to more than 15 percent of a national bank's unimpaired capital and surplus to a single borrower on an unsecured basis (12 USC 84(a)(1)); these limits also prohibit a national bank from lending an additional 10 percent on a secured basis (12 USC 84(a)(2)). The national bank lending limits apply only to "loans and extensions of credit," and the limits do not include most off-balance-sheet transactions that may provide significant sources of exposure to correspondents. Additionally, the national bank lending limits do not apply to overnight fed funds loans, a significant source of short-term exposure to correspondents. State limits generally do not apply to a broader range of transactions than the national bank limits, although some states include fed funds transactions within their limits.

State-chartered banks generally are subject to lending limits under state law. Almost all states impose lending limits on the banks they charter. Most of these limits are patterned on the national bank lending limits, although the specific percentages or transactions covered vary. The state limits generally do not apply to a broader range of off-balance-sheet transactions, although some states include fed funds transactions within their limits. A number of states, however, exclude interbank transactions from their lending limits entirely.

LIMITS ON INTERBANK LIABILITIES

Regulation F, Limitations on Interbank Liabilities (12 CFR 206), implemented section 308 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which amended section 23 of the Federal Reserve Act (12 USC 371b-2). Section 23, as amended, requires the Board of Governors of the Federal Reserve System (the Board) to prescribe standards to limit the risks posed by exposure of banks to other domestic depository institutions and foreign banks. Regulation F sets forth these standards. All depository institutions insured by the FDIC are subject to the Federal Reserve Board's Regulation F.[6] Regulation F was first adopted in 1992 and has remained substantially the same, except for the technical amendments adopted by the Board on September 10, 2003. (See 68 *Fed. Reg.* 53,283.) Regulation F consists of two primary parts: (1) prudential standards that apply to exposures generally (section 206.3) and (2) special rules that apply to credit exposure under certain circumstances (section 206.4).

The "Prudential Standards" section requires depository institutions to develop and adopt internal policies and procedures to evaluate and control all types of exposures to correspondents with which they do business.[7] Policies and procedures are to be established and maintained to prevent excessive exposure to any individual correspondent in relation to the condition of the correspondent. The "Prudential Standards" section requires a bank to adopt internal exposure limits when the financial condition of the correspondent and the form or maturity of the exposure create a significant risk that payments will not be made in full or on time. This section also provides that a bank shall structure the transactions of a correspondent or monitor exposures to a correspondent such that the bank's exposure ordinarily does not exceed its internal limits.

The "Credit Exposure" section provides that a bank's internal limit on interday *credit exposure* to an individual correspondent may not be more than 25 percent of the exposed bank's total capital, unless the bank can demonstrate that its correspondent is at least "adequately capitalized," as defined in section 206.5(a) of the rule. No limit is specified for credit exposure to correspondents that are at least adequately capitalized, but prudential standards are required for all correspondents, regardless of capital level. The term *correspondent* includes both domestically chartered depository institutions that are FDIC insured and foreign banks; the term does not include a commonly controlled correspondent.

6. Correspondent is defined in section 206.2(c) of Regulation F to mean a U.S. depository institution or a foreign bank to which a bank has exposure, but does not include commonly controlled correspondents.

7. Banks had to have the internal policies and procedures in place on June 19, 1993.

Prudential Standards

Standards for Selecting Correspondents

Banks are to address the risk arising from exposure to a correspondent, taking into account the financial condition of the correspondent and the size, form, and maturity of its exposure to the correspondent. Banks must adopt internal policies and procedures that evaluate the credit and liquidity risks, including operational risks, in selecting correspondents and terminating those relationships. Depository institutions are permitted to adopt flexible policies and procedures in order to permit resources to be allocated in a manner that will result in real reductions in risk. The policies and procedures must be reviewed annually by the bank's board of directors, but individual correspondent relationships need not be approved by the board. Examiners should determine that the policies and procedures adopted by the board provide for a determination of the credit, liquidity, and operational risks of a correspondent when the relationship with the correspondent is established and as it is maintained.[8] Additionally, if the bank has significant operational risk—such as relying on a correspondent for extensive data processing—that exposure could also lead to liquidity problems. This exposure may not be an issue for institutions that are not operationally dependent on any particular correspondent. Many banks may also address this exposure elsewhere in their operational procedures.

A bank's policies and procedures should provide for periodic review of the financial condition of any correspondent to which the bank has significant exposure. This review should evaluate whether the size and maturity of the exposure is commensurate with the correspondent's financial condition.[9] Factors bearing on the financial condition of the correspondent include, but are not necessarily limited to, (1) the capital level of the correspondent, (2) the level of nonaccrual and past-due loans and leases, and (3) the level of earnings.

Examiners should determine that a bank has periodically reviewed the financial condition of any correspondent to which the bank has significant exposure. The frequency of these reviews will depend on the size and maturity of the exposure and the condition of the correspondent. For example, the policies of many banks provide for an extensive annual review of a correspondent's financial condition; such policies may also provide for less extensive interim reviews under some circumstances, such as when exposure to a correspondent is very high or when a correspondent has experienced financial difficulty. A bank need not require periodic review of the financial condition of all correspondents. For example, periodic reviews would not be necessary for a correspondent to which the bank has only insignificant levels of exposure, such as small balances maintained for clearing purposes.[10] Significant levels of exposure should reflect those amounts that a prudent bank believes deserve analysis for risk of loss.

A bank may base its review of the financial condition of a correspondent on publicly available information, such as bank Call Reports, financial statements or reports, Uniform Bank Performance Reports, or annual reports, or the bank may use financial information obtained from a rating service. A bank generally is not required to obtain nonpublic information to use as the basis for its analysis and review of the financial condition of a correspondent.[11] For

8. *Liquidity risk* and *operational risk* are terms used in the definition of exposure. Liquidity risk is the risk that payment will be delayed for some period of time. For example, a bank is subject to the liquidity risk that a payment due from a failed correspondent will not be made on time; the bank's credit risk may be a lesser amount due to later distributions from the correspondent's receiver. Liquidity risk is included in the definition of exposure.

Operational risk is the risk that a correspondent's operational problems may prevent it from making payments, thereby creating liquidity risks for other banks. For example, a computer failure at a correspondent that a bank relies on for extensive data processing support may prevent the correspondent from making payments, and thus may create liquidity problems for the bank and other banks as well. Operational risk is also included in the definition of exposure.

9. Because exposure to a Federal Reserve Bank or Federal Home Loan Bank poses minimal risk to a respondent, Federal Reserve Banks and Federal Home Loan Banks are not included in the definition of correspondent.

10. Other forms of exposure that generally would not be considered significant include (1) a collecting bank's risk that a check will be returned, (2) an originating bank's risk that an automated clearinghouse (ACH) debit transfer will be returned or its settlement reversed, (3) a receiving bank's remote risk that settlement for an automated credit transfer could be reversed, or (4) a credit card transaction. In these types of transactions, the amounts involved are generally small, and the exposed bank usually has prompt recourse to other parties.

11. A bank *is* required to obtain nonpublic information to evaluate a correspondent's condition for those foreign banks for which no public financial statements are available. In these limited circumstances, the bank would need to obtain financial information for its review (including information obtained directly from the correspondent).

correspondents with which a bank has a significant relationship, a bank may have considerable nonpublic information, such as information on the quality of management, general portfolio composition, and similar information, but such information is not always available and is not required.

Regardless of whether public or nonpublic sources of information are used, a bank may rely on another party, such as a bank rating agency, its bank holding company, or another correspondent, to assess the financial condition of or select a correspondent, provided that the board of directors has reviewed and approved the general assessment or selection criteria used by that party. Examiners should ascertain that the bank reviews and approves the assessment criteria used by such other parties. Additionally, when a bank relies on its bank holding company to select and monitor correspondents—or relies on a correspondent, such as a bankers' bank, to choose other correspondents with which to place the bank's federal funds or other deposits—examiners should ensure that the bank has reviewed and approved the selection criteria used.

Internal Limits on Exposure

When the financial condition of the correspondent and the form or maturity of the exposure represent a significant risk that payments will not be made in full or in a timely manner, a bank's policies and procedures must limit its exposure to the correspondent, either by the establishment of internal limits or by other means. Limits are to be consistent with the risks undertaken, considering the financial condition and the form and maturity of the exposure to the correspondent. Limits may specify fixed exposure amounts, or they may be more flexible and be based on factors such as the monitoring of exposure and the financial condition of the correspondent. Different limits may be set for different forms of exposure, different products, and different maturities.

When a bank has exposure to a correspondent that has a deteriorating financial condition, examiners should determine if the bank took that deterioration into account when it evaluated the correspondent's creditworthiness. The examiner should also evaluate if the bank's level of exposure to the correspondent was appropriate.

Examiners need to determine that the bank's policy and procedural limits are consistent with the risk undertaken, given the maturity of the exposure and the condition of the correspondent. Inflexible dollar limits may not be necessary in all cases. As stated earlier, limits can be flexible and be based on factors such as the level of the bank's monitoring of its exposure and the condition of the correspondent. For example, a bank may choose not to establish a specific limit on exposure to a correspondent when the bank is able to ascertain account balances with the correspondent on a daily basis, because such balances could be reduced rapidly if necessary. In appropriate circumstances, a bank may establish limits for longer-term exposure to a correspondent, while not setting limits for interday (overnight) or intraday (within the day) exposure. Generally, banks do not need to set one overall limit on their exposure to a correspondent. Banks may prefer instead to set separate limits for different forms of exposure, products, or maturities. A bank's evaluation of its overall facility with a correspondent should take into account utilization levels and procedures for further limiting or monitoring overall exposure.

When a bank has established internal limits for its significant exposure, examiners should ensure that the bank either (1) has procedures to monitor its exposure to remain within established limits or (2) structures transactions with the correspondent to ensure that the exposure ordinarily remains within the bank's established internal limits. While some banks may monitor actual overall exposure, others may establish individual lines for significant sources of exposure, such as federal funds sales. For such banks, the examiner should ensure that the bank has established procedures to ensure that exposure generally remains within the established lines. In some instances, a bank may accomplish this objective by establishing limits on exposure that are monitored by a correspondent, such as for sales of federal funds through the correspondent as agent.

When a bank monitors its exposures, the appropriate level of monitoring will depend on (1) the type and volatility of the exposure, (2) the extent to which the exposure approaches the bank's internal limits for the correspondent, and (3) the condition of the correspondent. Generally, monitoring may be conducted retrospectively. Examples of retrospective monitoring include checking close-of-business balances at a correspondent for the prior day or obtaining daily balance records from a correspondent at the end of each month. Thus, banks are not expected to monitor exposure to correspondents on a real-time basis.

The purpose of requiring banks to monitor or structure their transactions that are subject to limits is to ensure that the bank's exposure generally remains within established limits. However, occasional excesses over limits may result from factors such as unusual market disturbances, unusual favorable market moves, or other unusual increases in activity or operational problems. Unusual late incoming wires or unusually large foreign cash letters (international pouch) would be considered examples of activities that could lead to excesses over internal limits and that would not be considered impermissible under the rule. Examiners should verify that banks have established appropriate procedures to address any excesses over internal limits.

A bank's internal policies and procedures must address intraday exposure. However, as with other exposure of longer maturities (i.e., interday or longer), the rule does not necessarily require that limits be established on intraday exposure. Examiners should expect to see such limits or frequent monitoring of balances only if the size of the intraday exposure and the condition of the correspondent indicate a significant risk that payments will not be made as contemplated. Examiners should keep in mind that intraday exposure may be difficult for a bank to actively monitor and limit. Consequently, like interday exposure, intraday exposure may be monitored retrospectively. In addition, smaller banks may limit their focus on intraday exposure to being aware of the range of peak intraday exposure to particular institutions and the effect that exposure may have on the bank. For example, a bank may receive reports on intraday balances from a correspondent on a monthly basis and would only need to take actions to limit or more actively monitor such exposure if the bank becomes concerned about the size of the intraday exposure relative to the condition of the correspondent.

Credit Exposure

A bank's internal policies and procedures must limit overnight credit exposure to an individual correspondent to not more than 25 percent of the exposed bank's total capital, unless the bank can demonstrate that its correspondent is at least adequately capitalized.[12] The credit exposure of a bank to a correspondent shall consist of the bank's assets and off-balance-sheet items that are (1) subject to capital requirements under the capital adequacy guidelines of the bank's primary federal supervisor and (2) involve claims on the correspondent or capital instruments issued by the correspondent.[13] Credit exposure therefore includes items such as deposit balances with a correspondent, fed funds sales, and credit-equivalent amounts of interest-rate and foreign-exchange-rate contracts and other off-balance-sheet transactions. Credit exposure does not include settlement of transactions, transactions conducted in an agency or similar capacity where losses will be passed back to the principal or other party, and other sources of exposure that are not covered by the capital adequacy guidelines or that do not involve exposure to a correspondent.[14] A bank may exclude the following from the calculation of credit exposure to a correspondent: (1) transactions, including reverse repurchase agreements, to the extent that the transactions are secured by government securities or readily marketable collateral; (2) the proceeds of checks and other cash items depos-

12. Total capital is the total of a bank's tier 1 and tier 2 capital calculated according to the risk-based capital guidelines of the bank's primary federal supervisor. For an insured branch of a foreign bank organized under the laws of a country that subscribes to the principles of the Basel Capital Accord, *total capital* means total tier 1 and tier 2 capital as calculated under the standards of that country. For an insured branch of a foreign bank organized under the laws of a country that does not subscribe to the principles of the Basel Capital Accord, *total capital* means total tier 1 and tier 2 capital as calculated under the provisions of the accord. The limit on credit exposure of the insured branch of a foreign bank is based on the foreign bank's total capital, as defined in this section, not on the imputed capital of the branch.

For purposes of Regulation F, an adequately capitalized correspondent is a correspondent with a total risk-based capital ratio of 8.0 percent or greater, a tier 1 risk-based capital ratio of 4.0 percent or greater, and a leverage ratio of 4.0 percent or greater. The leverage ratio does not apply to correspondents that are foreign banks. See section 206.5(e) for definitions of these terms.

13. A bank is required to include with its own credit exposure 100 percent of the credit exposure of any subsidiary that the bank is required to consolidate on its bank Call Report. This provision generally captures the credit exposure of any majority-owned subsidiary of the bank. Therefore, none of a minority-owned subsidiary's exposure and all of a majority-owned subsidiary's exposure would be included in the parent bank's exposure calculation.

14. For example, when assets of a bank, such as securities, are held in safekeeping by a correspondent, there is no exposure to the correspondent, even though the securities themselves may be subject to a capital charge.

ited in an account at a correspondent that are not yet available for withdrawal, (3) quality assets on which the correspondent is secondarily liable, or obligations of the correspondent on which a creditworthy obligor in addition to the correspondent is available; (4) exposure that results from the merger with or acquisition of another bank for one year after that merger or acquisition is consummated; and (5) the portion of the bank's exposure to the correspondent that is covered by federal deposit insurance. (See section 206.4(d) for a more detailed discussion of these exclusions.) This regulatory limit on credit exposure should be implemented as part of the bank's policies and procedures required under the "Prudential Standards" section. Regulation F does not impose regulatory limits for "credit exposure" to adequately or well-capitalized correspondents.

Quarterly monitoring of capital is only required for correspondents to which a bank's potential credit exposure is more than 25 percent of its total capital.[15] If the internal systems of a bank ordinarily limit credit exposure to a correspondent to 25 percent or less of the exposed bank's total capital, no monitoring of the correspondent's capital would be necessary, although periodic reviews of the correspondent's financial condition may be required under the "Prudential Standards" section if exposure to the correspondent is significant. Every effort should be made to allow banks to use existing risk-monitoring and -control systems and practices when these systems and practices effectively maintain credit exposure within the prescribed limits. For smaller institutions, it is relatively easy to determine how their measure of exposure compares with the definition of credit exposure in Regulation F because these institutions have relatively simple types of exposure. Examiners should remember that the regulation emphasizes appropriate levels of exposure based on the exposed bank's analysis of the creditworthiness of its correspondents. Accordingly, for those correspondents that the bank has not demonstrated are at least adequately capitalized, this limit should be viewed as a maximum credit-exposure level rather than as a safe-harbor level of credit exposure.

Examiners should ensure that the bank has in place policies and procedures that ensure the quarterly monitoring of the capital of its domestic correspondents. This quarterly schedule allows the bank to pick up information from the correspondent's most recent bank Call Report, financial statement, or bank rating report. Currently, it is difficult to obtain information on the risk-based capital levels of a correspondent. Regulation F requires that a bank must be able to demonstrate only that its correspondent's capital ratios qualify it as at least adequately capitalized.

A bank is not limited to a single source of information for capital ratios. A bank may rely on capital information obtained from a correspondent, a bank rating agency, or another reliable source of information. Further, examiners should anticipate that most banks will receive information on their correspondent's capital ratios either directly from the correspondents or from a bank rating agency. The standard used in the rule is based solely on capital ratios and does not require disclosure of CAMELS ratings. For foreign bank correspondents, monitoring frequency should be related to the frequency with which financial statements or other regular reports are available. Although such information is available quarterly for some foreign banks, financial statements for many foreign banks are generally available only on a semiannual basis.

Information on risk-based capital ratios may not be available for many foreign bank correspondents. As with domestic correspondents, however, examiners should anticipate that in most instances the correspondent will provide the information to the banks with which it does business.

A bank's internal policies and procedures should limit overnight credit exposure to a correspondent to not more than 25 percent of the exposed bank's total capital, unless the bank can demonstrate that its correspondent is at least adequately capitalized, as defined by the rule. However, examiners should not necessarily expect banks to have formal limits on credit exposure to a correspondent for which the bank does not maintain quarterly capital information or that is a less than adequately capitalized correspondent if the banks' policies and procedures effectively limit credit exposure to an amount below the 25 percent limit of total capital. Such situations include those in which

15. Because information on risk-based capital ratios for banks is generally based on the bank Call Report, a bank would be justified in relying on the most recently available reports based on Call Report data. While there may be a significant lag in such data, Call Reports are useful for monitoring trends in the condition of a correspondent—especially when a bank follows the data on a continuing basis.

only small balances are maintained with the correspondent or in which the correspondent has only been approved for a limited relationship. Although in many cases it will be necessary for a bank to establish formal internal limits to meet the regulatory limit, the provisions of section 206.3 (prudential standards) concerning excesses over internal limits also apply to limits established for the purpose of controlling credit exposure under section 206.4 of Regulation F.

The following examination objectives should be considered when examiners are (1) evaluating the bank's interbank liabilities with respect to its credit exposures to correspondents and (2) assessing the bank's compliance with Regulation F.

1. To determine if the policies, practices, procedures, and internal controls for interbank liabilities adequately address the risks posed by the bank's exposure to other domestic depository institutions and foreign banks.
2. To determine if bank officers and employees are operating in compliance with the policies and procedures established by the bank.
3. To determine if the financial condition of correspondents to which the bank has significant exposure—significant both in the size and maturity of the exposure and the financial condition of the correspondent—is reviewed periodically.
4. To determine if internal limits on exposure (1) have been established where necessary and (2) are consistent with the risk undertaken.
5. To determine if (1) exposure ordinarily remains within the established internal limits and (2) appropriate procedures have been established to address excesses over internal limits.
6. To determine that a bank's credit exposure to less than adequately capitalized correspondents is not more than 25 percent of the exposed bank's total capital. (Note that Regulation F places greater emphasis on maintaining appropriate levels of exposure based on a bank's analysis of the creditworthiness of its correspondents as opposed to merely staying within regulatory established limits.)
7. To determine if those correspondents to which the bank has credit exposure exceeding 25 percent of total capital are monitored quarterly to ensure that such correspondents remain at least adequately capitalized.
8. To reach agreement with the board of directors and senior management to initiate corrective action when policies, procedures, or internal controls are deficient, or when there are violations of laws or regulations.

Examiners should obtain or prepare the information necessary to perform the appropriate procedural steps.

1. If selected for implementation, complete or update the “Interbank Liabilities” section of the internal control questionnaire.
2. On the basis of an evaluation of the bank’s internal controls, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures.
4. Request bank files relating to its exposure to its correspondents, as exposure is defined in Regulation F and applied and used in the “Prudential Standards” section of the regulation.

   a. Request documentation demonstrating that the bank has periodically reviewed the financial condition of any correspondent to which the depository institution has significant exposure. Factors bearing on the financial condition of the correspondent that should be addressed by the bank (depository institution) include the capital level of the correspondent, the level of nonaccrual and past-due loans and leases, the level of earnings, and other factors affecting the financial condition of the correspondent.
   b. Request that the bank provide information indicating its level of exposure to each correspondent, as measured by the bank’s internal control systems (for smaller banks, this information may include correspondent statements and a list of securities held in the investment portfolio).
   c. Determine if the frequency of the bank’s reviews of its correspondents’ financial condition is adequate for those correspondents to which the bank has very large or long maturities or for correspondents in deteriorating condition.
   d. If a bank relies on another party (such as a bank rating agency, its bank holding company, or another correspondent) to provide financial analysis of a correspondent, determine if the bank’s board of directors has reviewed and approved the assessment criteria used by the other party.
   e. When the bank relies on its bank holding company or on a correspondent, such as a bankers’ bank, to select and monitor correspondents or to choose other correspondents with which to place the depository institution’s federal funds, ensure that the bank’s board of directors has reviewed and approved the selection criteria used.
   f. If the bank is exposed to a correspondent that has experienced deterioration in its financial condition, ascertain whether the bank has taken the deterioration into account in its evaluation of the creditworthiness of the correspondent and of the appropriate level of exposure to the correspondent.
   g. When the bank has established internal limits for significant exposure, determine that the bank either monitors its exposure or structures transactions with the correspondent to ensure that exposure ordinarily remains within the bank’s internal limits for the risk undertaken.
   h. If the bank chooses to set separate limits for different forms of exposure, products, or maturities and does not set an overall internal limit on exposure to a correspondent, review information on actual interday exposure to determine if the aggregate exposure (especially for less than adequately capitalized correspondents or financially deteriorating correspondents) is consistent with the risk undertaken.
   i. When a bank monitors its exposures, determine if the level of monitoring of significant exposure (especially for less than adequately capitalized correspondents or financially deteriorating correspondents) is adequate, commensurate with the type and volatility of exposure, the extent to which the exposure approaches the bank’s internal limits, and the condition of the correspondent.
   j. Determine if the bank had any occasional excesses in exposure over its internal

limits. If so, verify that the bank used appropriate and adequate procedures to address such excesses.

k. If the size of intraday exposure to a correspondent and the condition of the correspondent indicate a significant risk that payments will not be made in full or in a timely manner, verify that the bank has established intraday limits consistent with the risk undertaken and that it has monitored its intraday exposure.

5. Request and review a list of the correspondent transaction files for all domestic depository institutions and foreign banks to which the bank regularly has credit exposure (as defined in section 206.4 of Regulation F) exceeding 25 percent of the bank's total capital during a specified time interval. (Where appropriate, every effort should be made to allow banks to use existing risk-monitoring and -control systems and practices when these systems and practices effectively maintain credit exposure within the prescribed limits). Review the bank's files to—
   a. verify that the correspondent's capital levels are monitored quarterly;
   b. verify that these correspondents are at least adequately capitalized, in compliance with Regulation F; and
   c. determine that the credit exposure to those correspondents that are at risk of dropping below the adequately capitalized capital levels could be reduced to 25 percent or less of the bank's total capital in a timely manner.

Review the bank's internal controls, policies, practices, and procedures for interbank liabilities and compliance with the Board's Regulation F. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. When identifying and resolving any existing deficiencies, examiners should seek the answers to the following key questions.

PRUDENTIAL STANDARDS

1. Has the bank developed written policies and procedures to evaluate and control its exposure to all of its correspondents?
2. Have the written policies and procedures been reviewed and approved by the board of directors annually?
3. Do the written policies and procedures adequately address the bank's exposure(s) to a correspondent, including credit risk, liquidity risk, operational risk, and settlement risk?
4. Has the bank adequately evaluated its intraday exposure? Does the bank have significant exposure to its correspondent from operational risks, such as extensive reliance on a correspondent for data processing? If so, has the bank addressed these operational risks?
5. Do the bank's written policies and procedures establish criteria for selecting a correspondent or terminating that relationship?
6. Do the bank's written policies and procedures require a periodic review of the financial condition of a correspondent whenever the size and maturity of exposure is considered significant in relation to the financial condition of the correspondent?
7. When exposure is considered significant, is the financial condition of a correspondent periodically reviewed?
8. Does the periodic review of a correspondent's financial condition include—
   a. the level of capital?
   b. the level of nonaccrual and past-due loans and leases?
   c. the level of earnings?
   d. other factors affecting the financial condition of the correspondent?
9. If a party other than bank management conducts the financial analysis of or selects a correspondent, has the bank's board of directors reviewed and approved the general assessment and selection criteria used by that party?
10. If the financial condition of a correspondent, or the form or maturity of the bank's exposure to that correspondent, creates significant risk, do the bank's written policies and procedures establish internal limits or other procedures, such as monitoring, to control exposure?
11. Are the bank's internal limits or controls appropriate for the level of its risk exposure to correspondents? If no internal limits have been established, is this appropriate based on the financial condition of a correspondent and the size, form, and maturity of the bank's exposure? What are your reasons for this conclusion?
12. When internal limits for significant exposure to a correspondent have been set, has the bank established procedures and structured its transactions with the correspondent to ensure that the exposure ordinarily remains within the bank's established internal limits?
13. If not, is actual exposure to a correspondent monitored to ensure that the exposure ordinarily remains within the bank's established internal limits?
14. Is the level (frequency) of monitoring performed appropriate for—
    a. the type and volatility of the exposure?
    b. the extent to which the exposure approaches the bank's internal limits?
    c. the financial condition of the correspondent?
15. Are transactions and monitoring reports on exposure reviewed for compliance with internal policies and procedures? If so, by whom and how often?
16. Do the bank's written policies and procedures address deterioration in a correspondent's financial condition with respect to—
    a. the periodic review of the correspondent's financial condition?
    b. appropriate limits on exposure?
    c. the monitoring of the exposure, or the

structuring of transactions with the correspondent, to ensure that the exposure remains within the established internal limits?

Are these measures appropriate and realistic?

17. Do the bank's written procedures establish guidelines to address excesses over its internal limits? (Such excesses could include unusual late incoming wires, unusually large foreign cash letters (international pouch), unusual market moves, or other unusual increases in activity or operational problems.) Are the procedures appropriate?

CREDIT-EXPOSURE LIMITS

1. Do the bank's written policies and procedures effectively limit overnight credit exposure to 25 percent or less of the bank's total capital, if a correspondent is less than adequately capitalized?
2. If credit exposure is not limited to 25 percent or less of the bank's total capital, does the bank—
   a. obtain quarterly information to determine its correspondent's capital levels (if so, determine the source of the information)?
   b. monitor its overnight credit exposure to its correspondents (if so, determine the frequency)?

This interagency guidance reminds institutions of supervisory expectations on sound practices for managing risks associated with funding and credit concentrations arising from correspondent relationships (correspondent concentration risk).[1] The guidance highlights the need for institutions to identify, monitor, and manage correspondent concentration risk on a standalone and organization-wide basis and to take into account exposures to the correspondents' affiliates as part of their prudent risk-management practices. Institutions also should be aware of their affiliates' exposures to correspondents as well as the correspondents' subsidiaries and affiliates. The guidance also reinforces the supervisory view that financial institutions should perform appropriate due diligence on all credit exposures to, and funding transactions with, other financial institutions. See SR-10-10 and its attachments. Also see 75 *Fed. Reg.* 23764, May 4, 2010.

INTERAGENCY GUIDANCE ON CORRESPONDENT CONCENTRATION RISKS

A financial institution's[2] relationship with a correspondent[3] may result in credit (asset) and funding (liability) concentrations. On the asset side, a credit concentration represents a significant volume of credit exposure that a financial institution has advanced or committed to a correspondent. On the liability side, a funding concentration exists when an institution depends on one or a few correspondents for a disproportionate share of its total funding.

The Federal Reserve[4] realizes some concentrations meet certain business needs or purposes, such as a concentration arising from the need to maintain large ''due from'' balances to facilitate account clearing activities. However, correspondent concentrations represent a lack of diversification, which adds a dimension of risk that management should consider when formulating strategic plans and internal risk limits.

The Federal Reserve considers credit exposures greater than 25 percent of total capital[5] as concentrations. While a liability concentration threshold has not been established, the Federal Reserve has seen instances where funding exposures as low as 5 percent of an institution's total liabilities have posed an elevated liquidity risk to the recipient institution.

These levels of credit and funding exposures are not firm limits but indicate an institution has concentration risk with a correspondent. Such relationships warrant robust risk-management practices, particularly when aggregated with other similarly sized funding concentrations, in addition to meeting the minimum regulatory requirements specified in applicable regulations. Financial institutions should identify, monitor, and manage both asset and liability correspondent concentrations and implement procedures to perform appropriate due diligence on all credit exposures to and funding transactions with correspondents, as part of their overall risk-management policies and procedures.

This guidance does not supplant or amend applicable regulations, such as the Board's *Limitations on Interbank Liabilities* (Regulation F).[6] This guidance clarifies that financial institutions should consider taking actions beyond the minimum requirements established in Regulation F to identify, monitor, and manage correspondent concentration risks in order to maintain risk-management practices consistent with safe and sound operations, especially when there are rapid changes in market conditions or in a correspondent's financial condition.

1. See, for example, section 2015.1 or SR-93-36.
2. This guidance applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, and savings and loan holding companies and their subsidiaries that are supervised by the Board of Governors of the Federal Reserve System.
3. Unless the context indicates otherwise, references to ''correspondent'' include the correspondent's holding company, subsidiaries, and affiliates. A correspondent relationship results when a financial organization provides another financial organization a variety of deposit, lending, or other services.
4. The interagency guidance references, collectively, the Agencies, meaning the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).
5. For purposes of this guidance, the term ''total capital'' means the total risk-based capital as reported for commercial banks and thrifts in the Report of Condition and the Thrift Financial Report, respectively.
6. 12 CFR 206. All depository institutions insured by the FDIC are subject to the Board's Regulation F.

Identifying Correspondent Concentrations

Institutions should implement procedures for identifying correspondent concentrations. For prudent risk-management purposes, these procedures should encompass the totality of the institutions' aggregate credit and funding concentrations to each correspondent on a standalone basis, as well as take into account exposures to each correspondent organization as a whole.[7] In addition, the institution should be aware of exposures of its affiliates to the correspondent and its affiliates.

Credit Concentrations

Credit concentrations can arise from a variety of assets and activities. For example, an institution could have due from bank accounts, federal funds sold on a principal basis and direct or indirect loans to, or investments in, a correspondent. In identifying credit concentrations for risk-management purposes, institutions should aggregate all exposures, including but not limited to

- due from bank accounts (demand deposit accounts (DDA) and certificates of deposit (CD));
- federal funds sold on a principal basis;
- the over-collateralized amount on repurchase agreements;
- the under-collateralized portion of reverse repurchase agreements;
- net current credit exposure on derivatives contracts;
- unrealized gains on unsettled securities transactions;
- direct or indirect loans to, or for the benefit of, the correspondent;[8] and
- investments, such as trust preferred securities, subordinated debt, and stock purchases, in the correspondent.

7. Financial institutions should identify and monitor all direct or indirect relationships with their correspondents. Institutions should take into account exposures of their affiliates to correspondents and how those relationships may affect the institution's exposure. While each financial institution is responsible for monitoring its own credit and funding exposures, institution holding companies, if any, should manage their organizations' concentration risk on a consolidated basis.

8. Exclude loan participations purchased without recourse from a correspondent, its holding company, or an affiliate.

Funding Concentrations

Depending on its size and characteristics, a concentration of credit for a financial institution may be a funding exposure for the correspondent. The primary risk of a funding concentration is that an institution will have to replace those advances on short notice. This risk may be more pronounced if the funds are credit sensitive or if the financial condition of the party advancing the funds has deteriorated.

The percentage of liabilities or other measurements that may constitute a concentration of funding is likely to vary depending on the type and maturity of the funding and the structure of the recipient's sources of funds. For example, a concentration in overnight unsecured funding from one source might raise different concentration issues and concerns than unsecured term funding, assuming compliance with covenants and diversification with short- and long-term maturities. Similarly, concerns arising from concentrations in long-term unsecured funding typically increase as these instruments near maturity.

Calculating Credit and Funding Concentrations

When identifying credit and funding concentrations for risk-management purposes, institutions should calculate both gross and net exposures to the correspondent on a standalone basis and on a correspondent organization-wide basis as part of their prudent risk-management practices. Exposures are reduced to net positions to the extent that the transactions are secured by the net realizable proceeds from readily marketable collateral or are covered by valid and enforceable netting agreements. Appendix A and appendix B contain examples, which are provided for illustrative purposes only.

Monitoring Correspondent Relationships

Prudent management of correspondent concentration risks includes establishing and maintaining written policies and procedures to prevent excessive exposure to any correspondent in relation to the correspondent's financial condition. For risk-management purposes, institutions' procedures and frequency for monitoring correspondent relationships may be more or less aggressive depending on the nature, size, and risk of the exposure.

In monitoring correspondent relationships for risk-management purposes, institutions should specify internal parameters relative to what information, ratios, or trends will be reviewed for each correspondent on an ongoing basis. In addition to a correspondent's capital, level of problem loans, and earnings, institutions may want to monitor other factors, which could include but are not limited to

- deteriorating trends in capital or asset quality.
- reaching certain target ratios established by management (for example, aggregate of non-accrual and past due loans and leases as a percentage of gross loans and leases).
- increasing level of other real estate owned.
- attaining internally specified levels of volatile funding sources such as large CDs or brokered deposits.
- experiencing a downgrade in its credit rating, if publicly traded.
- being placed under a public enforcement action.

For prudent risk-management purposes, institutions should implement procedures that ensure ongoing, timely reviews of correspondent relationships. Institutions should use these reviews to conduct comprehensive assessments that consider their internal parameters and are commensurate with the nature, size, and risk of their exposure. Institutions should increase the frequency of their internal reviews when appropriate, as even well-capitalized institutions can experience rapid deterioration in their financial condition, especially in economic downturns.

Institutions' procedures also should establish documentation requirements for the reviews conducted. In addition, the procedures should specify when relationships that meet or exceed internal criteria are to be brought to the attention of the board of directors or the appropriate management committee.

Managing Correspondent Concentrations

Institutions should establish prudent internal concentration limits, as well as ranges or tolerances for each factor being monitored for each correspondent. Institutions should develop plans for managing risk when these internal limits, ranges, or tolerances are met or exceeded, either on an individual or collective basis. Contingency plans should provide a variety of actions that could be considered relative to changes in the correspondent's financial condition. However, contingency plans should not rely on temporary deposit insurance programs for mitigating concentration risk.

Prudent risk management of correspondent concentration risks should include procedures that provide for orderly reductions of correspondent concentrations that exceed internal parameters over a reasonable timeframe that is commensurate with the size, type, and volatility of the risk in the exposure. Such actions could include, but are not limited to

- reducing the volume of uncollateralized/uninsured funds.
- transferring excess funds to other correspondents after conducting appropriate reviews of their financial condition.
- requiring the correspondent to serve as agent rather than as principal for federal funds sold.
- establishing limits on asset and liability purchases from, and investments in, correspondents.
- specifying reasonable timeframes to meet targeted reduction goals for different types of exposures.

Examiners will review correspondent relationships during examinations to ascertain whether an institution's policies and procedures appropriately identify and monitor correspondent concentrations. Examiners also will review the adequacy and reasonableness of institutions' contingency plans to manage correspondent concentrations.

Performing Appropriate Due Diligence

Financial institutions that maintain credit exposures in, or provide funding to, other financial institutions should have effective risk-management programs for these activities. For this purpose, credit or funding exposures may include but are not limited to due from bank accounts; federal funds sold as principal; direct or indirect loans (including participations and syndications); trust preferred securities; subordinated debt; and stock purchases of the correspondent.

An institution that maintains or contemplates entering into any credit or funding transactions with another financial institution should have written investment, lending, and funding policies and procedures, including appropriate limits, that govern these activities. In addition, these procedures should ensure that the institution conducts an independent analysis of credit transactions prior to committing to engage in the transactions. The terms for all such credit and funding transactions should strictly be on an arm's-length basis; conform to sound investment, lending, and funding practices; and avoid potential conflicts of interest.

APPENDIX A

Calculating Respondent *Credit Exposures* on an *Organization-Wide* Basis

Respondent Bank's *Gross Credit Exposure* to a Correspondent, its Holding Company, and Affiliates	
Due from DDA with correspondent	$ 50,000,000
Due from DDA with correspondent's two affiliated insured depository institutions (IDIs)	1,000,000
CDs issued by correspondent bank	1,000,000
CDs issued by one of correspondent's two affiliated IDIs	500,000
Federal funds sold to correspondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	2,500,000
Reverse repurchase agreements	3,750,000
Net current credit exposure on derivatives[1]	250,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates	4,500,000
Investments in the correspondent, its holding company, or affiliates	2,500,000
Gross Credit Exposure	**$117,500,000**
Total Capital	**$100,000,000**
Gross Credit Concentration	**118%**

Respondent Bank's *Net Credit Exposure* to a Correspondent, its Holding Company, and Affiliates	
Due from DDA (less checks/cash not available for withdrawal and federal deposit insurance (FDI))[2]	$ 17,850,000
Due from DDA with correspondent's two affiliated IDIs (less FDI)[2]	500,000
CDs issued by correspondent bank (less FDI)	750,000
CDs issued by one of correspondent's two affiliated IDIs (less FDI)	250,000
Federal funds sold on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	2,500,000
Under-collateralized amount on reverse repurchase agreements (less the current market value of government securities or readily marketable collateral pledged)[3]	100,000
Uncollateralized net current derivative position[1]	50,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates	4,500,000
Investments in the correspondent, its holding company, or affiliates	2,500,000
Net Credit Exposure	**$ 80,500,000**
Total Capital	**$100,000,000**
Net Credit Concentration	**81%**

APPENDIX A—*continued*

Calculating Correspondent *Funding Exposures* on an *Organization-Wide* Basis

Correspondent's *Gross Funding Exposure* to a Respondent Bank	
Due to DDA with respondent	$ 50,000,000
Correspondent's two affiliated IDIs' due to DDA with respondent	1,000,000
CDs sold to respondent bank	1,000,000
CDs sold to respondent from one of correspondent's two affiliated IDIs	500,000
Federal funds purchased from respondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	2,500,000
Repurchase Agreements	1,000,000
Gross Funding Exposure	**$ 107,500,000**
Total Liabilities	**$1,350,000,000**
Gross Funding Concentration	**7.96%**

Correspondent's *Net Funding Exposure* to a Respondent, its Holding Company, and Affiliates	
Due to DDA with respondent (less checks and cash not available for withdrawal and FDI)[2]	$ 17,850,000
Correspondent's two affiliated IDIs' due to DDA with respondent (less FDI)[2]	500,000
CDs sold to correspondent (less FDI)	750,000
One of correspondent's two affiliated IDIs' CDs sold to respondent (less FDI)[2]	250,000
Federal funds purchased from respondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	2,500,000
Under-collateralized amount of repurchase agreements relative to the current market value of government securities or readily marketable collateral pledged[3]	150,000
Net Funding Exposure	**$ 73,500,000**
Total Liabilities	**$1,350,000,000**
Net Funding Concentration	**5.44%**

Note: Respondent bank has $1 billion in total assets, comprising 10 percent of total assets or $100 million in total capital and 90 percent of total assets or $900 million in total liabilities. The correspondent has $1.5 billion in total assets, comprising 10 percent of total assets or $1.15 million in total capital and 90 percent of total assets or $1.35 billion in total liabilities.

1. There are five derivative contracts with a mark-to-market fair value position as follows: Contract 1 ($100,000), Contract 2 + $400,000, Contract 3 ($50,000), Contract 4 +$150,000, and Contract 5 ($150,000), subtotal of $250,000 fair value for the derivative contracts. Subtracting the pledged collateral's fair value of $200,000 leaves a subtotal of $50,000 or a net uncollateralized position of $50,000.

2. While temporary deposit insurance programs may provide certain transaction accounts with higher levels of federal deposit insurance coverage, institutions should not rely on such programs for mitigating concentration risk.

3. Government securities means obligations of, or obligations fully guaranteed as to principal and interest by, the U.S. government or any department, agency, bureau, board, commission, or establishment of the United States, or any corporation wholly owned, directly or indirectly, by the United States.

APPENDIX B

Calculating Respondent *Credit Exposures* on a *Correspondent-Only* Basis

Respondent Bank's *Gross Credit Exposure* to a Correspondent	
Due from DDA with correspondent	$ 50,000,000
Due from DDA with correspondent's two affiliated IDIs	0
CDs issued by correspondent bank	1,000,000
CDs issued by one of correspondent's two affiliated IDIs	0
Federal funds sold to correspondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	0
Reverse repurchase agreements	3,750,000
Net current credit exposure on derivatives[1]	250,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates	4,500,000
Investments in the correspondent, its holding company, or affiliates	2,500,000
Gross Credit Exposure	**$113,500,000**
Total Capital	**$100,000,000**
Gross Credit Concentration	**114%**

Respondent Bank's *Net Credit Exposure* to a Correspondent	
Due from DDA (less checks/cash not available for withdrawal and FDI)[2]	$ 17,850,000
Due from DDA with correspondent's two affiliated IDIs (less FDI)[2]	0
CDs issued by correspondent bank (less FDI)	750,000
CDs issued by one of correspondent's two affiliated IDIs (less FDI)	0
Federal funds sold on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	0
Under-collateralized amount on reverse repurchase agreements (less the current market value of government securities or readily marketable collateral pledged)[3]	100,000
Uncollateralized net current derivative position[1]	50,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates	4,500,000
Investments in the correspondent, its holding company, or affiliates	2,500,000
Net Credit Exposure	**$ 77,250,000**
Total Capital	**$100,000,000**
Net Credit Concentration	**77%**

APPENDIX B—*continued*

Calculating Correspondent *Funding Exposures* on a *Correspondent-Only* Basis

Correspondent's *Gross Funding Exposure* to a Respondent	
Due to DDA with respondent	$ 50,000,000
Correspondent's two affiliated IDIs' due to DDA with respondent	0
CDs sold to respondent bank	1,000,000
CDs sold to respondent from one of correspondent's two affiliated IDIs	0
Federal funds purchased from respondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	0
Repurchase agreements	1,000,000
Gross Funding Exposure	**$ 103,500,000**
Total Liabilities	**$1,350,000,000**
Gross Funding Concentration	**7.67%**

Correspondent's *Net Funding Exposure* to a Respondent	
Due to DDA with respondent (less checks and cash not available for withdrawal and FDI)[2]	$ 17,850,000
Correspondent's two affiliated IDIs' due to DDA with respondent (less FDI)[2]	0
CDs sold to correspondent (less FDI)	750,000
One of correspondent's two affiliated IDIs' CDs sold to respondent (less FDI)[2]	0
Federal funds purchased from respondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	0
Under-collateralized amount on repurchase agreements (less the current market value of government securities or readily marketable collateral pledged)[3]	100,000
Net Funding Exposure	**$ 70,200,000**
Total Liabilities	**$1,350,000,000**
Net Funding Concentration	**5.20%**

Note: Respondent bank has $1 billion in total assets, comprising 10 percent of total assets or $100 million in total capital and 90 percent of total assets or $900 million in total liabilities. The correspondent has $1.5 billion in total assets, comprising 10 percent of total assets or $1.15 million in total capital and 90 percent of total assets or $1.35 billion in total liabilities.

1. There are five derivative contracts with a mark-to-market fair value position as follows: Contract 1 ($100,000), Contract 2 + $400,000, Contract 3 ($50,000), Contract 4 +$150,000, and Contract 5 ($150,000), subtotal of $250,000 fair value. Adding the collateral's fair value of $200,000 leaves a subtotal of $450,000 or a net uncollateralized position of $50,000.

2. While temporary deposit insurance programs may provide certain transaction accounts with higher levels of federal deposit insurance coverage, institutions should not rely on such programs for mitigating concentration risk.

3. Government securities means obligations of, or obligations fully guaranteed as to principal and interest by, the U.S. government or any department, agency, bureau, board, commission, or establishment of the United States, or any corporation wholly owned, directly or indirectly, by the United States.

SCOPE OF BANK SECRECY ACT/ANTI-MONEY-LAUNDERING CONTENT IN THIS MANUAL

The purpose of this section is to provide a brief introduction of the Bank Secrecy Act (BSA) and anti-money-laundering (AML) compliance program and suspicious activity reporting requirements for banks under Regulation H.[1] For additional detail on the BSA/AML program, suspicious activity reporting requirements and all other laws and regulations pertaining to the BSA, examination objectives and procedures as well as supervisory expectations, refer to the *Federal Financial Institutions Examination Council (FFIEC) BSA/AML Examination Manual*. BSA requirements and expectations are briefly covered in other sections of this manual, including "Cash Accounts," "Deposit Accounts," "Private Banking Activities," and "Managing Outsourcing Risks." Also, refer to the *BSA/AML Examination Manual* for objectives and procedures for conducting Office of Foreign Assets Control examinations.

INTRODUCTION

Banks should take reasonable and prudent steps to combat money laundering and terrorist financing and to minimize their vulnerability to the risks associated with such activities. Banks encounter legal and compliance risks when failing to implement adequate controls within their organization to comply with the BSA and other applicable AML laws and regulations. Each bank under supervision of the Federal Reserve is required to establish and maintain a BSA compliance program,[2] implement a customer identification program,[3] and identify and report suspicious activity.[4] In addition, the regulations promulgated by the Financial Crimes Enforcement Network (FinCEN), the administrator of the BSA and a bureau of the Department of the Treasury, require banks to guard against money laundering and terrorist financing.[5]

A review of the BSA/AML compliance program is required at each full-scope examination of an insured depository institution and is an important aspect of safety-and-soundness examinations.[6] In supervising state member banks, evaluating the adequacy of the BSA/AML compliance program would generally help inform the rating of the management component of the Uniform Financial Institutions Rating System. The management rating reflects the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of a bank's activities and to ensure a safe, sound, and efficient operation in compliance with applicable laws and regulations. The impact of BSA/AML compliance problems on the management rating should be assessed on a case-by-case basis, and will depend on the severity of the issues at the bank. Examiners evaluate the adequacy of a bank's BSA/AML compliance program relative to its risk profile and its compliance with applicable laws and regulations, recognizing that banks vary in focus and complexity, and that these differences create for each bank a unique risk profile.[7] In addition to influencing ratings, consideration of a bank's effectiveness in combating money laundering activities is a required component of the application process.[8] As such, BSA/AML problems can have an impact on a bank's strategic plan.

Certain federal and state government agencies play a critical role in implementing BSA regulations, developing examination guidance, ensuring compliance with the BSA, and enforcing the BSA. These agencies include the U.S. Treasury, FinCEN, various state banking agencies and the federal banking agencies.[9] The federal

1. Federal Reserve supervised institutions that are subject to the BSA include state member banks (Regulation H, 12 CFR 208), bank holding companies (Regulation Y, 12 CFR 225), Edge and agreement corporations, and foreign banking organizations operating in the United States (Regulation K, 12 CFR 211).
2. 12 CFR 208.63.
3. 12 CFR 208.63(b)(2).
4. 12 CFR 208.62.
5. 31 CFR 1010 (general provisions) and 31 CFR 1020 (rules for banks).
6. 12 USC 1818(s)(2).
7. See SR letter 19-11, "Joint Statement on Risk-Focused Bank Secrecy Act/Anti-Money Laundering Supervision."
8. See SR letter 14-2, "Enhancing Transparency in the Federal Reserve's Applications Process," and SR letter 02-8, "Implementation of Section 327 of the USA PATRIOT Act in the Applications Process," for more information.
9. The federal banking agencies include the Board of

banking agencies may use their authority, as granted under section 8 of the Federal Deposit Insurance Act (FDIA), to enforce compliance with appropriate banking rules and regulations, including compliance with the BSA. FinCEN, as administrator of the BSA, may also pursue civil enforcement actions when warranted.

REGULATION H

The Board's Regulation H requires a state member bank to establish a BSA compliance program and file suspicious activity reports (SAR). In accordance with the Board's regulation, a bank's BSA compliance program must be in writing and approved by its board of directors, with the approval noted in the board minutes. As part of its overall BSA compliance program, a bank is required to develop and implement a customer identification program. At a minimum, the BSA compliance program must

- provide for a system of internal controls to assure ongoing compliance;
- provide for independent testing for compliance to be conducted by bank personnel or by an outside party;
- designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance; and
- provide training for appropriate personnel.

The Board's regulations also require a bank to report certain activity to law enforcement that may be useful to the government in criminal, tax, or regulatory proceedings. A bank must electronically file a SAR with FinCEN no later than 30 calendar days in the following circumstances of suspected unlawful activity:

- insider abuse involving any amount;
- violations aggregating $5,000 or more in which a suspect can be identified;
- violations aggregating $25,000 or more regardless of a potential suspect; or
- transactions aggregating $5,000 or more that involve potential money laundering or violations of the BSA.

Suspicious activity reporting is one of the many tools that law enforcement authorities use to combat money laundering, terrorist financing, and other financial crimes. A SAR and any information that would reveal the existence of a SAR are confidential, except as is necessary to fulfill BSA obligations and responsibilities.

For comprehensive information regarding the BSA Compliance Program and SAR filing requirements, including examination procedures, please refer to the FFIEC *Bank Secrecy Act/Anti-Money Laundering Examination Manual*.

COMMUNICATIONS OF SUPERVISORY FINDINGS ABOUT COMPLIANCE WITH THE BSA

When examiners identify supervisory concerns related to a bank's BSA/AML compliance in the course of an examination, they should communicate those concerns as outlined in this manual in the section entitled "Examination Strategy and Risk-Focused Examinations." Generally, findings would be contained in the report of examination or in other formal communication. This includes Matters Requiring Immediate Attention (MRIAs), Matters Requiring Attention (MRAs), and violations of law.

For more serious issues of noncompliance, the Federal Reserve Board has a broad range of formal and informal enforcement powers. For more information on enforcement actions, refer to the enforcement actions section of this manual and consult with staff of the Board of Governors.

REPORTING OF SUSPECTED CRIMINAL VIOLATIONS BY FEDERAL RESERVE

The Board has outlined procedures for the referral to law enforcement of potential criminal activity identified during the supervisory process through the filing of a SAR with FinCEN. The Board has also established steps that Board and Reserve Bank staff should follow with respect to the reporting of suspicious activity.

Examiners should focus on whether a financial institution has an effective SAR decision-making process, not individual SAR decisions. Examiners may review individual SAR decisions as a means to test the effectiveness of the SAR monitoring, detecting, reporting, and deci-

Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency.

sionmaking process. If, for example, during the course of an examination an examiner determines that a financial institution's failure to file a SAR is indicative of significant suspected illegal activity or deficient SAR processes that warrants criticism, these findings should be expressly communicated to the bank's management. The examiner should document the situation, including any response or corrective action taken by management to address the examiner's concerns. In general, examiners should also cite the bank in the report of examination (ROE) for an apparent violation of law. If the suspicious activity involves an insider, an examiner must not disclose the existence of a SAR filing to the subject of the SAR, who may have access to the ROE or other correspondence. In these instances, examiners should consult Board staff to determine the appropriate course of action.

Limited circumstances may exist where a financial institution is unwilling or unable to report suspicious activity to law enforcement. The Federal Reserve has developed specific procedures for examiners for requesting consideration of a SAR filing with law enforcement. The Board's Legal Division has primary responsibility for the referral of criminal matters for the Federal Reserve System to the appropriate law enforcement authorities. The Board may make a referral to law enforcement by filing a SAR with FinCEN. Importantly, the Board's ability to file a SAR is only one method of making a referral to law enforcement and other referral methods may be more appropriate depending on the facts and circumstances. For example, the Board's Legal Division may contact the U.S. Department of Justice directly to make a referral in certain circumstances. In determining whether the Board should file a SAR, staff from the Board's Legal Division may consider a variety of factors, including any prior communications with law enforcement regarding the activity.

INTRODUCTION

The Depository Institution Management Interlocks Act (Interlocks Act), as implemented by Regulation L (12 CFR 212) and Subpart J of Regulation LL (12 CFR 238.91-.99), prohibits a management official of a depository institution or depository institution holding company from serving simultaneously as a management official of another depository organization if the organizations are not affiliated and both either are very large or are located in the same local area.[1] The Interlocks Act fosters competition among depository organizations by prohibiting interlocking relationships of management officials where the management interlock likely would have an anticompetitive effect. The Board's regulations implementing the Interlocks Act apply to management officials of state member banks, depository institution holding companies, and their affiliates.

PROHIBITIONS

The Interlocks Act and the Federal Reserve Board's implementing regulations generally prohibit management interlocks in the following three situations, unless the interlock is otherwise exempted:

1. *Community prohibition:* Restricts management interlocks between unaffiliated depository organizations if the organizations in question (or a depository institution affiliate thereof) have offices in the same "community" as defined in the regulations.
2. *Relevant metropolitan statistical area (RMSA) prohibition:* Restricts management interlocks between unaffiliated depository organizations if each has total assets of $50 million or more, and both depository organizations, or any of their depository institution affiliates, have offices in the same RMSA.
3. *Major assets prohibition:* Restricts management interlocks between two unaffiliated depository organizations, each with total assets exceeding $10 billion (or any affiliate of such organizations), regardless of the location of the two depository organizations.[2]

STATUTORY AND REGULATORY EXEMPTIONS

The Interlocks Act includes several specific exemptions from the general interlocks prohibitions. Under these statutory exemptions (codified in 12 USC 3204 and 3205, and set forth in 12 CFR 212.4 and 12 CFR 238.94), the Interlocks Act permits a management interlock for the following organizations and persons:

- an Edge or agreement corporation;
- a depository organization in formal liquidation or a similar type situation;
- a credit union being served by a management official of another credit union;
- a depository institution that does not do business in the United States except as an incident to its activities outside the United States;
- a state-chartered savings and loan guaranty corporation;
- a Federal Home Loan Bank or other bank organized solely for the purpose of serving depository institutions or solely for the purpose of providing securities clearing services and related services related to other depository institutions;
- a depository organization that is closed or is in danger of closing as determined by the appropriate federal depository institution's regulatory agency and is acquired by another depository organization; or
- a diversified savings and loan holding company (as defined in section 10(a)(1)(F) of the Home Owners' Loan Act (12 USC 1467a(a)(1)(F)) with respect to the service of a director of such company who also is a director of an unaffiliated depository organization.

The Interlocks Act also provides general authority for the Federal Reserve Board to

1. The Board's rules define "depository organizations" to include depository institutions and depository holding companies. The Board has authority under the Interlocks Act to prescribe regulations necessary to carry out the Interlocks Act with respect to state member banks, bank holding companies, and savings and loan holding companies (12 USC 3207(2)). For more information on management official interlocks at savings and loan holding companies, see the Federal Reserve Board's Regulation LL (12 CFR 238 subpart J).

2. 84 *Fed. Reg.* 54,465 (October 10, 2019).

establish exemptions through its regulations. The Federal Reserve Board has used this authority to establish the small market share exemption and other general exemptions.

Under the small market share exemption (12 CFR 212.5 and 12 CFR 238.95), a management interlock is permissible if (1) the interlock is not prohibited by major asset prohibition, and (2) the depository organizations (and their depository institution affiliates) hold, in the aggregate, no more than 20 percent of the deposits in each RMSA or community in which both depository organizations (or their depository institution affiliates) have offices. The amount of deposits is determined by reference to the most recent annual Summary of Deposits published by the Federal Deposit Insurance Corporation for the RMSA or community. Small market share exemptions are automatic, contingent on the interlocked depository organizations maintaining sufficient records to support the determination of eligibility and must be reconfirmed on an annual basis.

In addition, the Federal Reserve Board may exempt a prohibited interlock in response to an application by a depository organization if the Federal Reserve Board finds that the interlock would not result in a monopoly or substantial lessening of competition, and would not present safety and soundness concerns. Section 212.6(b) of Regulation L, as well as section 238.96(b) of Regulation LL, identifies certain proposals that are presumed not to result in a monopoly or substantial lessening of competition. These are

- depository organizations primarily serving low- and moderate-income areas,
- depository organizations controlled or managed by members of a minority group or by women,
- depository institutions that have been chartered for fewer than two years, and
- depository organizations in "troubled condition" as defined in the Federal Reserve Board's Regulation Y.[3]

An exemption obtained pursuant to 12 CFR 212.6(a) or 238.96(a) may continue for so long as it does not result in a monopoly or substantial lessening of competition, or is unsafe or unsound. If the Federal Reserve Board grants an interlock exemption in reliance upon a presumption listed at 12 CFR 212.6(b) or 12 CFR 238.96(b), the interlock may continue for three years, unless otherwise provided by the Board in writing.

CHANGE IN CIRCUMSTANCES

A management official must terminate their service or apply for an exemption if a change in circumstances causes the management interlock to become prohibited (see 12 CFR 212.7 and 238.97). A change in circumstances may include an increase in asset size of a depository organization, a change in the delineation of the RMSA or community, the establishment of an office, an increase in the aggregate deposits of the depository organization, or an acquisition, merger, consolidation, or reorganization of the ownership structure of a depository organization that causes a previously permissible interlock to become prohibited.

A management interlock that becomes prohibited due to a change in circumstances under 12 CFR 212.7 or 12 CFR 238.97 may continue for 15 months following the date of the change in circumstances. The Federal Reserve Board may shorten this period under appropriate circumstances.

3. The Board's Regulation Y (12 CFR 225.71) states that troubled condition for a regulated institution means an institution that (1) has a composite rating, as determined in its most recent report of examination or inspection, of 4 or 5 under the CAMELS rating system or the Federal Reserve Bank Holding Company rating system; (2) is subject to a cease-and-desist order or formal written agreement that requires action to improve the financial condition of the institution, unless otherwise informed in writing by the Board or Reserve Bank; or (3) is informed in writing by the Board or Reserve Bank that it is in troubled condition for purposes of the requirements of subpart H of Regulation Y on the basis of the institution's most recent report of condition or report of examination or inspection, or other information available to the Board or Reserve Bank. Note that with the Federal Reserve Bank Holding Company rating system, there is no presumption that a firm rated "Deficient-1" would be deemed to be in "troubled condition." Whether a firm subject to the Federal Reserve Bank Holding Company rating system rated "Deficient-1" receives a "troubled condition" designation will be determined by the facts and circumstances at that firm. However, firms rated "Deficient-1" due to financial weaknesses in either capital or liquidity would be more likely to be deemed in "troubled condition" than firms rated "Deficient-1" due solely to issues of governance or controls. See 83 *Fed. Reg.* 58,724 (November 21, 2018) and 84 *Fed. Reg.* 4309 (February 15, 2019) for more information.

Regulation O: Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks

Effective date April 2020

PURPOSE AND APPLICABILITY

The Federal Reserve Board's Regulation O (12 CFR 215) implements many of the laws pertaining to extensions of credit by banks to their insiders.[1] Regulation O was issued pursuant to Sections 22(g) and 22(h) of the Federal Reserve Act. Regulation O is designed to mitigate the potential for conflicts of interest and self-dealing by individuals who may be in a position to influence a bank's lending decisions. The regulation limits the amount and type of credit that a member bank may extend to an insider and includes reporting and recordkeeping requirements for a member bank to track and report such activity. The regulation requires that extensions of credit to executive officers, directors, principal shareholders, and their related interests be made substantially on the same terms and follow credit underwriting procedures that are not less stringent than those prevailing at the time for comparable transactions with persons not covered by the regulation. In addition, such extensions of credit should not involve more than the normal risk of repayment or present other unfavorable features. Regulation O also imposes individual and aggregate lending limits and prior approval requirements for certain extensions of credit.

Moreover, certain extensions of credit to executive officers of member banks are subject to additional restrictions. In addition, a member bank is prohibited from making payments of overdrafts to directors or executive officers absent a written, preauthorized plan for the overdraft to be treated as an extension of credit that bears interest or a transfer of funds from another account at the bank.

With regards to applicability, the Federal Reserve's Regulation O governs any extension of credit by a member bank to an executive officer, director, or principal shareholder of

1. The member bank,
2. Any company of which the member bank is a subsidiary, and
3. Any other subsidiary of that company.

1. This section summarizes and explains the rule, as amended, but is not a substitute for the rule itself.

The regulation also applies to any extension of credit by a member bank to the related interests of executive officers, directors, or principal shareholders, including companies controlled by such a person and political or campaign committees that benefit or are controlled by such a person.

Extensions of credit by a member bank to its executive officers, directors, principal shareholders, and their related interests, as well as other items related to Regulation O, are reported on Schedule RC-M of the Consolidated Reports of Condition and Income (Call Report). For more information on reporting, refer to the appropriate Call Report form and instructions.

EXTENSION OF CREDIT (12 CFR 215.3)

Regulation O defines an "extension of credit" to include the making or renewal of any loan, a granting of a line of credit, or an extending of credit in any manner whatsoever including

1. A purchase under repurchase agreement of securities, other assets, or obligations;
2. An advance by means of an overdraft, cash item, or otherwise;
3. Issuance of a standby letter of credit (or other similar arrangement regardless of name or description) or an ineligible acceptance;
4. An acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which an insider may be liable as maker, drawer, endorser, guarantor, or surety;
5. An increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for (a) accrued interest or (b) taxes insurance, or other expenses incidental to the existing indebtedness;
6. An advance of unearned salary or other unearned compensation for a period in excess of 30 days; and
7. Any other similar transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or

because of an endorsement on an obligation or otherwise, or by any means whatsoever.[2]

The requirements of Regulation O apply at the time a loan or extension of credit is made, which is the time the bank enters into a binding commitment to make the extension of credit.[3] Thus, loans or extensions of credit that were made to an individual before they became an insider are grandfathered, as long as they were made in good faith and not in contemplation of the individual becoming an insider. If such loans exceed the amount permitted by Regulation O, they will be considered nonconforming rather than a violation of Regulation O. However, if the loans are nonconforming, no new extensions of credit subject to Regulation O may be made to the individual, and existing loans may not be renewed, except in compliance with Regulation O.[4]

LIMITS ON EXTENSIONS OF CREDIT TO INSIDERS (12 USC 375B AND 12 CFR 215.4)

Terms and Creditworthiness

Regulation O applies limits and prohibitions to extensions of credit made by a member bank to all insiders—executive officers, directors, and principal shareholders, and the related interests of these persons—including insiders of affiliates. Regulation O specifies that a member bank may not extend credit to an insider of the bank or an insider of the bank's affiliates unless the extension is made on substantially the same terms as other loans, in accordance with underwriting procedures used for other loans for comparable transactions, does not involve more than the normal risk of repayment, and does not present other unfavorable terms. Exceptions are provided for certain extensions of credit made pursuant to a benefit or compensation program that is widely available to all employees of the member bank and does not give preference over employees that are not insiders.

Prior Approval

Regulation O requires prior approval by the member bank's board of directors for extensions of credit that exceed the higher of $25,000 or 5 percent of the bank's unimpaired capital stock and surplus.[5] Such approval should be documented within the board's minutes, and the insider who would receive the loan should abstain from the board's approval process. In addition, if the extension of credit exceeds $500,000, it must follow the prior approval procedure.

Individual and Aggregate Lending Limits

Extensions of credit to insiders are restricted on an individual and aggregate level. No member bank may extend credit to any insider of the bank or insider of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit by the member bank to that person and to all related interests of that person, exceeds the lending limit of the member bank specified in 12 CFR 215.2(i). For loans that are not fully secured, this amount is 15 percent of the bank's unimpaired capital stock and unimpaired surplus. An additional 10 percent of the bank's unimpaired capital and unimpaired surplus is added for loans that are fully secured by readily marketable collateral having a market value—as determined by reliable and continuously available price quotations—that is at least equal to the amount of the loan. Additionally, a member bank may not extend credit to any insider of the bank or insider of its affiliates if the extension of credit is in an amount that, when aggregated with the amount of all outstanding extensions of credit by that bank to all insiders, exceeds the bank's unimpaired capital and unimpaired surplus.

2. The Dodd-Frank Wall Street Reform and Consumer Protection Act added to the definition of an "extension of credit" an insured depository institution's credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction. Refer to Regulation O for information on what an "extension of credit" does not include and for the other regulatory provisions.

3. 12 CFR 215.3(d).

4. For more information, see 22 *Fed. Res. Bull.* 121 (1936); *Fed. Res. Reg. Serv.* 3-1036; letter of J. Virgil Mattingly, Jr., General Counsel, Board of Governors of the Federal Reserve System (September 16, 1992), 1992 WL 693697 (FRB). See also the OCC's Interpretive Letter #1096 (March 20, 2008).

5. 12 CFR 215.4(b).

Overdrafts

In addition, a member bank is prohibited from paying an overdraft of an executive officer or director unless the overdraft is made pursuant to a written, preauthorized, interest-bearing extension-of-credit plan that specifies a method of repayment, or a written, preauthorized transfer of funds from another account of the insider at the bank. This prohibition does not apply to the payment of inadvertent overdrafts in aggregate of $1,000 or less, as long as the account was not overdrawn for more than five business days and the standard overdraft fee was charged.

EXTENSIONS OF CREDIT TO EXECUTIVE OFFICERS (12 USC 375A AND 12 CFR 215.5)

Regulation O imposes additional limits on extensions of credit to executive officers of member banks (but not to their related interests and not to executive officers of affiliates). Aggregate loans to an executive officer may not exceed the higher of $25,000 or 2.5 percent of the institution's unimpaired capital and surplus but in no event more than $100,000.

However, a member bank may extend credit to an executive officer of a member bank in any amount to finance or refinance

- the purchase, construction, maintenance, or improvement of a single residence of an executive officer if the loan is secured by a first lien on the residence that the executive officer owns (or expects to own after the extension of credit); or
- the education of their children.

An executive officer may have only one of each such loan from the member bank outstanding at a time. Certain secured loans may be permitted (12 CFR 215.5(c)(3)) in excess of the lending limit set by 12 CFR 215.5(c)(4). It is important to note that, although mortgage and educational loans are not subject to limitation under 12 USC 375a and 12 CFR 215.5, aggregate loans to an individual executive officer of a member bank (including mortgage and education loans) collectively are limited by 12 USC 375b and 12 CFR 215.4.

INSIDER USE OF A BANK-OWNED CREDIT CARD

Federal Reserve Board staff issued a May 22, 2006, legal opinion in response to a request for clarification from the Federal Deposit Insurance Corporation (FDIC) on the application of the Board's Regulation O to credit cards that are issued to bank insiders for the bank's business purposes. The FDIC asked whether, and under what circumstances, an insider's use of a bank-owned credit card would be deemed an extension of credit by the bank to the insider for purposes of Regulation O. The Federal Reserve Board staff's legal opinion applies only to the specific issues and circumstances described in the letter and does not address any other issues or circumstances. For more information, see the Federal Reserve Board's legal opinion on its public website.

SUPERVISORY CONSIDERATIONS

Business transactions between a member bank and insiders require close supervisory review. Many of these transactions are soundly structured and have a legitimate business purpose so that all parties are treated equitably. However, absent the protection of an arm's-length transaction, the potential for or appearance of abuse is greater and necessitates intensified review. A member bank's extension of credit to an insider may be considered abusive or self-serving if its terms are unfavorable to the lender or if the credit would not have been extended on the same terms to a non-insider. That is, it would be improbable that each party to the credit would have entered into the credit transaction under the same terms if the relationship did not exist.

Examiners should pay close attention to credit extensions of a member bank to its insiders and their related interests. Extensions of credit to insiders or their related interests should be reviewed to determine whether the amount of credit extended, both to a single borrower and in aggregate to all borrowers, conform to the provisions of Regulation O. Furthermore, examiners should review the terms of the credit, particularly interest rate and collateral terms, to ensure no preferential treatment was given, and the credit does not involve more than a normal repayment risk. Documentation of comparable transactions must be available for examiner review in order to determine that the terms of substantially the same as third-party transactions and that the underwriting standards are not less stringent for insiders.

Examples of preferential treatment include

- lower interest rates than those other customers pay on similar type of loans;
- lower collateral requirements or unwarranted unsecured extensions of credit;
- longer maturities than typical for the nature and purpose of the loan;
- no personal guarantee of corporate debt if required from all other bank customers;
- a loan allowed for a purpose that would not be extended to other bank customers; and
- no requirement for a financial statement on the insider or other documentation that would be requested of other bank customers.

The examination procedures (ED modules) provide more information on assessing a member bank's compliance with Regulation O. If a credit extension appears to circumvent the intent of Regulation O, examiners should discuss the credit extension with the member bank's management to obtain additional information on the terms of the credit. Examiners should assess whether the potentially noncompliant credit extension was an inadvertent instance of noncompliance with Regulation O as well as whether the member bank incurred any losses as a result of the credit extension. The examiner and examiner-in-charge (EIC) should discuss with the member bank's management its plans to bring any noncompliant credit extension into compliance and the need for management to improve controls to prevent further instances of inadvertent noncompliance. Examiners should disclose the noncompliance credit extension(s) and any corresponding matters requiring attention in the report of examination, as appropriate.

For more serious apparent violations of Regulation O, such as intentional or systematic reporting issues, the EIC should raise the issue to Reserve Bank management. Examiners should also notify Reserve Bank management if it is unclear whether the borrower is subject to Regulation O. In these instances, Reserve Bank management will coordinate any necessary discussions with Reserve Bank Legal and/or Board Legal staff. If it is determined that supervisory corrective action is required, the EIC and Reserve Bank management will draft the informal or formal supervisory action in consultation with the Board enforcement staff. See also this manual's section on Formal and Informal Supervisory Actions for more information.

Status of Certain Investment Funds and Their Portfolio Investments for Purposes of Regulation O

The popularity of mutual funds, exchange traded funds, and similar index-based investment products has resulted in several large asset management companies becoming principal shareholders of a number of banks. These funds and products have triggered the Regulation O presumption of control of a related interest over an increasing number of companies in the asset managers' portfolios.

The Federal Reserve Board, the FDIC, and the OCC (agencies) issued an interagency statement in 2019 to explain that the agencies will exercise discretion in not taking enforcement action against banks or asset managers, which become principal shareholders of banks, with respect to certain extensions of credit by banks that otherwise would violate Regulation O. See SR-19-16 for more information.

As detailed in the statement, the agencies are providing this temporary relief while the Board, in consultation with the other agencies, considers whether to amend Regulation O to address this issue. The relief covers extensions of credit to fund complex-controlled portfolio companies only, and does not extend to any extension of credit to principal shareholder fund complexes. The statement provides more specific information on the application of Regulation O in this specific context.

Examination Procedures

Objective: Assess the bank's compliance with the Federal Reserve Board's Regulation O (12 CFR 215).

Regulation O governs any extension of credit by a bank to an insider, a term defined to include a director, executive officer, or principal shareholder of the bank, the bank holding company of the bank and any other subsidiary of the bank holding company. The regulation also applies to an extension of credit to insiders' related interests and prohibits preferential lending by a bank to insiders of another bank when there is a correspondent account relationship between the banks.

The purpose of Regulation O is to prevent insiders from using their positions and leverage to procure loans on more preferential terms or conditions than would otherwise be available to other customers of the bank.

Regulation O is made applicable to state nonmember banks by Section 18(j)(2) of the Federal Deposit Insurance Act. See also 12 CFR section 337.3 of FDIC Regulations.

Savings Associations: Savings associations, both state and Federal, are subject to Regulation O pursuant to section 11(b) of the Home Owners Loan Act (12 USC section 1468(b)). See also 12 CFR section 215.12.

PRELIMINARY REVIEW

1. Identify previous concerns by reviewing prior examination reports, file correspondence, and audits.
2. Review board minutes since the previous examination and note all discussions and votes related to borrowings of insiders and their related interests.
3. Request a list of extensions of credit to insiders and their related interests and review all internal reports used to monitor extensions of credit to insiders and their related interests.
4. Review internal audits and loan reviews pertaining to insider borrowings, and assess remedial actions taken by management to address prior audit, loan review, or examination findings.

POLICY CONSIDERATIONS

5. Determine whether the bank adopted written policies and procedures to address Regulation O requirements, such as
   - appropriately identifying executive officers, directors, principal shareholders, and their related interests of the bank and its affiliates as defined by section 215.2 of Regulation O;
   - appropriately identifying all extensions of credit related to insiders as defined by section 215.3 of the regulation, including those considered extensions under the tangible economic benefit rule;
   - ensuring extensions of credit to insiders are made at arm's length on substantially the same terms and following underwriting procedures that are not less stringent than those used for comparable transactions, do not give preference to any insider over other employees, and do not involve more than normal risk of repayment or present other unfavorable features as set forth in section 215.4(a);
   - ensuring appropriate prior approval of extensions of credit to insiders of the bank and its affiliates as delineated in section 215.4(b);
   - accurately aggregating extensions of credit to ensure compliance with individual and aggregate lending limits designated in sections 215.4(c) and 215.4(d), respectively;
   - identifying and monitoring transaction accounts of directors and executive officers of the bank and its affiliates to ensure compliance with section 215.4(e);
   - ensuring that all extensions of credit to executive officers of the bank do not exceed the regulatory limits as prescribed in section 215.5;
   - maintaining appropriate records necessary for compliance with section 215.8;
   - appropriately disclosing credit extended from banks to insiders and their related interests as mandated by section 215.9 (when requested in writing); and
   - ensuring that directors and executive officers report annually to the board any

outstanding credit secured by the shares of the bank not traded publicly (section 215.10).

MANAGEMENT INFORMATION SYSTEMS

6. Determine whether management information systems accurately identify and aggregate extensions of credit to insiders and their related interests.

SECTION 215.4 (A)—GENERAL PROHIBITIONS—TERMS AND CREDITWORTHINESS

Applies to insiders of the bank (executive officers, directors, principal shareholders, and their related interests), and to insiders of the bank's affiliates in most circumstances.

A bank may not extend credit to any insider of the bank or to an insider of its affiliates unless the extension of credit is made on substantially the same terms and conditions, and with underwriting standards that are not less stringent, than those terms and standards prevailing at the time for comparable transactions by the bank to non-insider customers.

In addition to the not-more-favorable terms requirements, an extension of credit to a bank insider or an insider of a bank affiliate may not involve more than the normal risk of repayment, or present other unfavorable features.

7. Review loans to insiders and their related interests and review a sample of similar loans to non-insiders. Determine whether insider loans were granted on terms and conditions more favorable than comparable transactions to non-insiders or other employees.

8. Determine whether any loans to insiders involved more than the normal risk of repayment or present other unfavorable features when compared with loans to non-insiders or other employees.

SECTION 215.4 (B)—PRIOR APPROVAL

Applies to insiders of the bank and in most circumstances to insiders of the bank's affiliates. Approval by the board is not required under this section for an extension of credit made pursuant to a line of credit approved under this section within 14 months of the date of the extension of credit. However, this extension of credit must still comply with section 215.4(a).

A majority of the board of directors must approve any extension of credit to an insider that, when aggregated with all other extensions of credit to that insider and their related interest, exceeds the higher of $25,000 or 5 percent of unimpaired capital and surplus, not to exceed $500,000 except by complying with the requirements of 215.4(b).

9. List any insiders and related interests to whom the bank has extended aggregate credit exceeding the threshold calculated above. For relevant time periods, review board minutes to ensure that those extensions exceeding the prior approval threshold were
   - pre-approved by a majority of the bank's board of directors, and
   - approved without the direct or indirect participation of the insider obtaining the loan.[1]

SECTION 215.4(C)—INDIVIDUAL LENDING LIMIT

Applies to insiders of the bank and in most circumstances to insiders of the bank's affiliates.

No bank may extend credit to an insider that, when aggregated with all other extensions to that insider and their related interests, exceeds the legal lending limit of the institution. The legal lending limit is generally 15 percent of capital plus an additional 10 percent if the additional 10 percent is fully secured by readily marketable collateral. The 10 percent limitation is separate from and in addition to the initial 15 percent limitation.

When state law establishes a lending limit for a bank that is lower than the amount permitted

1. Minutes typically reflect that the affected insiders excused themselves during the discussions and abstained from voting on those extensions of credit.

in this calculation, the state's lending limit is the applicable lending limit for the bank.

10. Determine whether managerial reports documenting loans to insiders and their related interests accurately aggregate extensions of credit. Review totals for each insider to assess compliance with calculated limits. Verify that loans segregated in the 10 percent category are fully secured by readily marketable collateral having a reliable and continuously available market value.
11. Determine whether loans to insiders and their related interests are not subject to exceptions to the Individual Lending Limit as outlined in Appendix to Part 215—Section 5200 of the Revised Statutes Total Loans and Extensions of Credit.

SECTION 215.4(D)—AGGREGATE LENDING LIMIT

Applies to insiders of the bank and in most circumstances to insiders of the bank's affiliates.

A bank may not extend credit to any insider of the bank or insider of its affiliates unless the amount of the extension of credit, when aggregated with the amount of all outstanding extensions of credit to all such insiders, does not exceed the bank's unimpaired capital and unimpaired surplus.

A bank with total deposits of less than $100 million may, by annual board resolution, adopt a higher aggregate lending limit not to exceed two times the bank's unimpaired capital and surplus if

- *the board of directors determines that such a high limit is consistent with prudent, safe and sound banking practices in light of the bank's experience in lending to its insiders and is necessary to attract or retain directors or to prevent restricting the availability of credit in small communities;*
- *the resolution sets forth the facts and reasoning on which the board of directors bases the finding, including the amount of the bank's lending to its insiders as a percentage of the bank's unimpaired capital and unimpaired surplus as of the date of the resolution;*
- *the bank meets or exceeds all applicable capital requirements established by the appropriate federal banking agency; and the bank received a satisfactory composite rating in its most recent report of examination.*

12. Determine whether extensions of credit to insiders and their related interests do not exceed the bank's unimpaired capital and unimpaired surplus or that those banks with less than $100 million in total deposits meet the criteria for the exception outlined above.
13. For banks that have adopted a resolution authorizing a higher limit but subsequently fail to meet the four requirements, verify that they have not extended any additional credit (including a renewal of any existing extension of credit) to any insider of the bank or its affiliates, unless such extensions of credit do not exceed the bank's unimpaired capital and surplus.
14. Verify that loans to insiders and their related interests are not subject to exceptions to the Aggregate Lending Limit as outlined in Appendix to Part 215—Section 5200(c) of the Revised Statutes Total Loans and Extensions of Credit.

SECTION 215.4(E)—OVERDRAFTS—TRANSACTION TESTING/SAMPLE REVIEW

Applies to executive officers and directors of the bank and in most circumstances those of its affiliates. It does not apply to related interests. It does not apply to principal shareholders, unless they are also an executive officer or director.

No bank may pay an overdraft of an executive officer or director of the bank or an executive officer or director of its affiliates on an account at the bank, unless the payment of funds is made in accordance with a written, preauthorized, interest-bearing extension-of-credit plan that specifies a method of repayment, or a written, preauthorized transfer of funds from another account of the account holder at the bank.

Certain inadvertent overdrafts on an executive officer or director account that total $1,000 or less are allowed provided

- *the account is not overdrawn for more than five business days, and*
- *the bank charges the same fee charged to any other customer of the bank in similar circumstances.*

15. Review overdraft, bounce protection, check kiting, uncollected funds, and large item reports for activity related to overdrafts of executive officers and directors of the bank and its affiliates. Determine whether any overdrafts were paid in contravention of established bank policies, such as no pay, all pay, or ad hoc overdraft arrangements.
16. Determine whether the bank has established written, preauthorized, interest bearing credit plans (overdraft protection) with executive officers or directors of the bank or executive officers or directors of its affiliates. Ensure that these plans specify a method of repayment and verify that the credit plans are performing as agreed.
17. Determine whether the bank has established written, preauthorized agreements for fund transfers from another account in the event of an overdraft. Determine whether any overdrafts noted in director or executive officers' accounts are covered by a transfer agreement.

ADDITIONAL RESTRICTIONS ON LOANS TO EXECUTIVE OFFICERS OF BANKS (SECTION 215.5)

Only applies to executive officers of the bank.

Aggregate loans to an executive officer may not exceed the higher of $25,000 or 2.5 percent of unimpaired capital and surplus and in no event more than $100,000, as defined in section 215.5.

There are no dollar limits on loans for the education of children or for the purchase, construction, maintenance, or improvement of a single residence if secured by a first lien and the residence is owned by the officer. Furthermore, there are no dollar limits on loans secured by U.S. government and agency securities or by a deposit account in the respective bank. The aggregate calculation should also exclude credit card debt of $15,000 or less [section 215.3(b)(5)] and indebtedness of $5,000 or less arising from an interest bearing overdraft credit plan [section 215.3(b)(6)].

18. Review extensions of credit made to executive officers or any partnerships in which one or more executive officers are partners, and individually or together, hold a majority interest, to determine that qualifying loans were made within applicable limits.

19. Review extensions of credit to executive officers and determine whether the loans were promptly reported to the board of directors. (Any extension of credit by a bank to an executive officer must be promptly reported to the bank's board of directors, and comply with the terms and creditworthiness requirements of section 215.4(a).) See also section 215.5(d).

20. Review loans files and other relevant documentation to ensure that reportable transactions were preceded by the submission of a detailed, current financial statement of the officer and include a condition that the extension will, at the option of the bank, become due and payable at any time that the officer is indebted to any other bank or banks in an aggregate amount greater than the limit for 215.5(c). See also section 215.5(d).

RECORDKEEPING AND REPORTING REQUIREMENTS—SECTIONS 215.8, 215.9, AND 215.10

Applies to insiders of banks and their affiliates; however, there are certain exclusions for directors and executive officers of affiliates. See section 215.2 for specific conditions under which directors and executive officers of affiliates can be excluded.

21. Determine whether the recordkeeping method adopted by the bank accurately maintains records of extensions of credit to insiders and their related interests as required by section 215.8.

22. Verify that the bank, upon receipt of written request from the public, has made available the names of each of its executive officers and principal shareholders to whom, or to whose related interests, the bank had an outstanding extension of credit, that when aggregated with all other outstanding extensions, equaled or exceeded 5 percent of capital and surplus, or $500,000, whichever amount is less. Verify that requests for this information and the disposition of such

requests are maintained for at least two years.[2]

23. If applicable, determine whether executive officers and directors of a bank whose shares are not publicly traded report annually to the board of directors of the bank any outstanding credit secured by shares of the bank. This requirement is only applicable to shares of bank stocks that are not publicly traded (section 215.10). (Note: Applies to executive officers and directors of the bank only.)
24. Determine whether extensions of credit from a correspondent bank to a respondent bank insider and from a respondent bank to a correspondent bank insider, as well as accounts opened by banks with a loan to an insider of a correspondent bank, are all on market terms. (Note: While the reporting requirements for lending from correspondent banks to insiders and from banks to the insiders of correspondent banks are no longer a requirement of Regulation O, the substantive restrictions remain a part of 12 USC 1972 (2).)

2. Disclosure is not required if the aggregate amount of all extensions of credit outstanding, including to related interests of such person, does not exceed $25,000.

OVERVIEW

The Fair and Accurate Credit Transactions Act of 2003 (FACT Act) was enacted on December 4, 2003.[1] The FACT Act added several provisions to the Fair Credit Reporting Act of 1970 (FCRA).[2] Section 114 of the FACT Act[3] amended section 615 of the FCRA, and directed the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Federal Trade Commission to issue joint regulations and guidelines regarding the detection, prevention, and mitigation of identity theft. Further, the agencies were directed to issue special regulations requiring debit and credit card issuers to validate notifications of changes of address under certain circumstances. In 2007, the agencies issued joint regulations and guidelines.[4] See section 222 of the Board's Regulation V—Fair Credit Reporting (12 CFR pt. 222).

The goal of the identity theft red flags rule (12 CFR pt. 222, Subpart J) and its Guidelines (12 CFR 222, Appendix J) is to ensure that financial institutions and creditors are alert for signs or indicators that an identity thief is misusing another individual's sensitive data, typically to obtain products or services from the institution or creditor. The identity theft red flags rule periodically requires a financial institution to determine whether it offers or maintains accounts covered by the regulation.[5] A covered account generally is a consumer account or any other account the institution determines carries a foreseeable risk of identity theft. For new or existing covered accounts, the regulation requires an institution to develop and implement a written Identity Theft Prevention Program (program) that is designed to detect, prevent, and mitigate identity theft. The program must be appropriate to the size and complexity of the financial institution and the nature and scope of its activities.

In general, safety-and-soundness examiners with experience in operational risk will review institutions for compliance with the identity theft red flags rule. This manual section explains certain financial institution safety-and-soundness provisions of the identity theft red flags rule and guidelines.

For additional information, see

- SR-08-7/CA-08-10, "Interagency Examination Procedures for the Identity Theft Red Flags and Other Regulations under the Fair Credit Reporting Act"
- Frequently Asked Questions on Identity Theft Rules (Jun. 11, 2009)
- The Board's Regulation V, "Fair Credit Reporting" (12 CFR pt. 222)

IDENTITY THEFT RED FLAGS PROGRAM

The term "account" is defined in the identify theft red flags rule as a continuing relationship established by a person with a financial institution or creditor to obtain a product or service for personal, family, household, or business purposes. The definition of "covered account" is divided into the following two parts:

(1) Accounts that a financial institution offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions; and
(2) Any other account that the financial institution offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution from identity theft.

1. Pub. L. 108–159.
2. 15 U.S.C. 1681 et seq.
3. 15 U.S.C. 1681m(e).
4. 72 Fed. Reg. 63,718 (Nov. 9, 2007).
5. The term financial institution means a "financial institution or creditor" with regard to the red flags program joint regulations and the accompanying interagency guidance. The FCRA definition of "financial institution" applies to: (1) all banks, savings associations, and credit unions, regardless of whether they hold a transaction account belonging to a consumer; and (2) any other person that directly or indirectly holds a transaction account belonging to a consumer. Accordingly, all banks, savings associations, and credit unions are covered by the red flags rules and Guidelines as "financial institutions," whether or not they hold a transaction account belonging to a consumer. Further, banks and savings associations, including those whose powers are limited to trust activities, are covered by the red flags rules and Guidelines. See also the Frequently Asked Questions on Identity Theft Rules (Jun. 11, 2009).

Risk Assessment

As part of developing and maintaining an effective program, a financial institution must initially and then periodically conduct a risk assessment to determine whether it offers or maintains covered accounts. The program must take into consideration (1) the methods it provides to open its accounts, (2) the methods it provides to access accounts, and (3) its previous experiences with identity theft.

If the financial institution determines that it has covered accounts, the risk assessment will enable it to identify which of its accounts the program must address. If a financial institution initially determines that it does not have covered accounts, the identity theft red flag rule requires the institution to periodically reassess whether it must develop and implement a program in light of changes in the accounts that it offers or maintains.

Elements of the Identity Theft Prevention Program

The elements of an institution's program will vary depending on the size and complexity of the financial institution. A financial institution that determines that it is required to establish and maintain a program must

- identify relevant red flags for its covered accounts,[6]
- detect and respond to the red flags that have been incorporated into its program,
- respond appropriately to the detected red flags, and
- periodically update the program to address the changing risks from identity theft associated with its customers and their accounts and to the safety and soundness of the financial institution.

Administration of the Identity Theft Prevention Program

Each financial institution or creditor that is required to implement a program must provide for the continued administration of the program by

- obtaining approval of the initial written program from either its board of directors or an appropriate committee of the board of directors;
- involving the board of directors, an appropriate committee thereof, or a designated employee at the level of senior management in the oversight, development, implementation, and administration of the program;
- training staff, as necessary, to effectively implement the program; and
- exercising appropriate and effective oversight of service provider arrangements.

GUIDELINES (12 CFR PT. 222, APPENDIX J)

Each financial institution that is required to implement an Identity Theft Prevention Program must consider the Guidelines for Identity Theft Detection, Prevention, and Mitigation's in Appendix J (12 CFR pt. 222, Appendix J) and include those guidelines that are appropriate in its program. Section I of the guidelines, "The Program," discusses an Identity Theft Prevention Program's design that may include, as appropriate, existing policies, procedures, and arrangements that control foreseeable risks to the institution's customers or to the safety and soundness of the financial institution from identity theft.

Identification of Red Flags

A financial institution should include red flags into its program from sources such as (1) incidents of identity theft that it has experienced, (2) methods of identity theft that have been identified as reflecting changes in identity theft risks, and (3) applicable supervisory guidance.

Categories of Red Flags

The program should follow the approach regarding the identification of red flags in section II(c) of the guidelines, "Categories of Red Flags," which provides guidance in identifying relevant red flags. No specific red flags are mandatory for all financial institutions, but a financial institu-

6. The red flags are patterns, practices, or specific activities that indicate the possible existence of identity theft or the potential to lead to identity theft.

tion should include, as appropriate:[7]

- alerts, notifications, or other warnings received from consumer reporting agencies or service providers, such as fraud detection services;
- the presentation of suspicious documents and personal identifying information, such as a suspicious address change;
- the unusual use of, or other suspicious activity related to, a covered account; and
- a notice received from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with covered accounts held by the financial institution.

The above categories do not represent a comprehensive list of all types of red flags that may indicate the possibility of identity theft. Institutions should also consider the types of covered accounts it offers and maintains, the methods it provides to open and access those accounts, and any previous exposures to identity theft.

Detect the Identity Theft Prevention Program's Red Flags

In accordance with section III of the guidelines, each financial institution's program should address the detection of red flags in connection with the opening of covered accounts and existing covered accounts. The policies and procedures regarding opening a covered account and existing covered accounts subject to the program should address the detection of red flags, such as by obtaining identifying information about, and verify the identity of, a person opening an account and, in the case of existing covered accounts, authenticating customers, monitoring transactions, and verifying the validity of change of address request.

Respond Appropriately to Any Detected Red Flags

Section IV of the guidelines, "Preventing and Mitigating Identity Theft," states that an institution's procedures should provide for appropriate responses to detected red flags that are commensurate with the degree of risk posed. When determining an appropriate response, the institution should consider factors that may heighten the institution's identity-theft risk. Such factors may include (1) a data security incident that results in unauthorized access to a customer's account records held by the financial institution, creditor, or third party, or (2) notice that a customer has provided information related to a covered account held by the financial institution or creditor to someone fraudulently claiming to represent the financial institution or creditor or to a fraudulent website.

Appropriate responses may include the following:

- monitoring a covered account for evidence of identity theft;
- contacting the customer;
- changing any passwords, security codes, or other security devices that permit access to a secured account;
- reopening a covered account with a new account number;
- closing an existing covered account;
- notifying law enforcement; or
- determining that no response is warranted under the particular circumstances.

Depending on the circumstances, refraining from making a response may be the most prudent course of action for the financial institution to prevent and mitigate identity theft. For example, the financial institution could elect to

- not open a new covered account; or
- not attempt to collect on a covered account or to sell a covered account to a debt collector.

Periodically Updating the Program's Relevant Red Flags

Section V of the guidelines, "Updating the Program," states that a financial institution should periodically update its program (including its relevant red flags) to reflect any changes in risks to its customers or to the safety and soundness of the institution from identity theft, based on (but not limited to) factors such as

7. Examples of red flags from each of these categories are appended as supplement A to appendix J.

- the experiences of the financial institution with identity theft;
- changes in methods of identity theft;
- changes in methods to detect, prevent, and mitigate identity theft;
- changes in the types of accounts that the financial institution offers or maintains; and
- changes in the financial institution's structure, including its mergers, acquisitions, joint ventures, and any business arrangements, such as alliances and service provider arrangements.

Administration of Program

Under the identity theft red flags rule, a financial institution that is required to implement a program must provide for the continued oversight and administration of its program. Section VI of the Guidelines, "Methods for Administering the Program," outlines steps to effectively administer the program.

The board of directors, an appropriate committee of the board, or a designated employee at the level of senior management should:

- assign specific responsibility for the program's implementation,
- review reports regarding the institution's compliance, and
- approve material changes to the program as necessary to address changing identity theft risks.

Financial institution staff responsible for developing, implementing, and administrating the program should report to the board of directors, an appropriate committee of the board, or a designated employee at the level of senior management at least annually. The report should address

- the effectiveness of the policies and procedures in addressing the risk of identity theft in connection with the opening of covered accounts and with respect to existing covered accounts;
- significant incidents involving identity theft and management's response;
- recommendations for material changes to the program; and
- service provider arrangements.

Whenever a financial institution engages a service provider to perform an activity in connection with one or more covered accounts, the institution should ensure that the activity of a service provider is conducted in accordance with reasonable policies and procedures designed to detect, prevent, and mitigate the risk of identity theft. For example, the financial institution could establish a contract with the service provider that specifies policies and procedures to detect relevant red flags that may arise in the performance of the service provider's activities, which should be mitigated and be reported to the financial institution or creditor.

SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT AND REGULATION W

Section 23A of the Federal Reserve Act (FRA) (12 USC 371c) is the primary statute governing transactions between a member bank and its affiliates. Section 23A (1) designates the types of companies that are affiliates of a bank; (2) specifies the types of transactions covered by the statute; (3) sets the quantitative limitations on a bank's covered transactions with any single affiliate, and with all affiliates combined; (4) sets forth collateral requirements for certain bank transactions with affiliates; and (5) requires all covered transactions to be conducted on terms consistent with safe and sound banking practices.

In addition to the statutory provisions of section 23A, the Board approved the issuance of Regulation W, which became effective April 1, 2003, implementing sections 23A and 23B of the FRA. To facilitate compliance with these statutes, the rule[1] provides several exemptions and combines the statutory restrictions on transactions between a member bank and its affiliates with numerous Board interpretations and exemptions that were previously issued.

Quantitative Limits

Section 23A(a)(1)(A) states that a member bank[2] may engage in a covered transaction with an affiliate if the aggregate amount of covered transactions with that particular affiliate does not exceed 10 percent of the member bank's capital stock and surplus. Sections 223.11 and 223.12 of the rule sets forth these quantitative limits. A bank that has crossed the 10 percent threshold with one affiliate may still conduct additional covered transactions with other affiliates, if transactions with all affiliates would not exceed 20 percent of the bank's capital stock and surplus.[3] The bank is prohibited from engaging in a new covered transaction with that affiliate if the bank's transactions would exceed the 10 percent threshold with that affiliate or if the level of covered transactions with all its affiliates would exceed the 20 percent threshold. The rule generally does not require the member bank to unwind existing covered transactions if the bank exceeds the 10 percent or 20 percent limit because its capital declined or a preexisting covered transaction increased in value.

The Board strongly encourages member banks with covered transactions in excess of the 10 percent threshold with any affiliate to reduce those transactions before expanding the scope or extent of the bank's relationships with other affiliates.

Capital Stock and Surplus

Under section 23A of the FRA, the quantitative limits on covered transactions are based on the "capital stock and surplus" of the member bank. Section 223.3(d) of the rule defines a member bank's capital stock and surplus, for the purposes of section 23A of the FRA, as (1) the sum of the member bank's tier 1 capital and tier 2 capital under the risk-based capital guidelines, (2) the balance of the bank's allowance for loan and lease losses not included in its tier 2 capital for the purposes of the risk-based capital calculation, and (3) the amount of any investment in a financial subsidiary that counts as a covered transaction that is required to be deducted from the bank's regulatory capital.[4]

Examiners can determine the amount of the quantitative limits based on the bank's most recent Consolidated Report of Condition and Income (Call Report).

1. In this section of the manual, Regulation W is referred to as "the rule" or by a specific section number of the rule.

2. Member bank is defined in section 223.3(w) as "any national bank, state bank, banking association, or trust company that is a member of the Federal Reserve System." Other provisions of federal law apply section 23A to state nonmember banks and savings associations. The rule also states that most subsidiaries of a member bank are to be treated as part of the member bank itself for purposes of sections 23A and 23B. The only subsidiaries of a member bank that are excluded from this treatment are financial subsidiaries, insured depository institution subsidiaries, and certain joint venture subsidiaries—companies that are generally deemed affiliates of the member bank under the rule. This treatment of subsidiaries reflects the fact that the statute typically does not distinguish between a member bank and its subsidiaries, and all the significant restrictions of the statute apply to actions taken by a member bank "and its subsidiaries."

3. See 12 USC 371c(a)(1). Sections 223.11 and 223.12 of the rule set forth these quantitative limits.

4. 12 CFR 223.3(d).

Affiliates

The definition of an affiliate is found in section 23A(b) of the FRA. Section 223.2 of Regulation W further defines "affiliate" as including

1. any company that controls[5] the member bank and any other company that is controlled by the company that controls the member bank;
2. any bank subsidiary of the member bank;
3. any company—
   - that is controlled directly or indirectly, by a 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; or
   - in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the member bank or any company that controls the member bank;
4. any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the member bank or any subsidiary or affiliate of the member bank;
5. any investment company with respect to which a member bank or any affiliate thereof is an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940 (the 1940 Act);
6. any investment fund for which the member bank or any affiliate of the member bank serves as an investment adviser, 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 (any investment fund or company with respect to which a member bank or affiliate thereof is an investment adviser; see section 608(a)(l)(A) of the Dodd-Frank Act);
7. a depository institution that is a subsidiary of the member bank;
8. a financial subsidiary of the member bank;
9. 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 of the other company[6] pursuant to the merchant banking authority in section 4(k)(4)(H) or (I) of the Bank Holding Company Act (BHC Act) (12 USC 1843(k)(4)(H) or (I));
10. 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. any subsidiary of an affiliate described in paragraphs (a)(1) through (10) of section 223.2 of Regulation W; and
12. any company that the Board, or the appropriate federal banking agency for the bank, determines by regulation or order to have a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship, to the detriment of the member bank or its subsidiary.

The following are not considered to be affiliates to a bank:

1. a nonbank subsidiary of that bank (other than a financial subsidiary) unless the Board determines not to exclude such a subsidiary;
2. a company engaged solely in holding that bank's premises;
3. a company engaged solely in conducting a safe deposit business;
4. a 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. a company in which control arises from the exercise of rights arising out of a bona fide debt previously contracted (for the period of time specified by section 23A).

5. By statute, "control" is defined as the power to (1) vote 25 percent or more of the voting shares of a company, (2) elect a majority of the directors of a company, or (3) exercise a controlling influence over a company.

6. The financial holding company may provide information acceptable to the Board demonstrating that it does not control the other company.

Definition of Affiliates by Type of Entity

Investment funds advised by the member bank or an affiliate of the member bank. Regulation W includes as an affiliate any company that is sponsored and advised on a contractual basis by the member bank or any of its affiliates,[7] as well as any investment company for which the member bank or its affiliate serves as an investment adviser, as defined in the 1940 Act.[8] In Regulation W, the Board used its statutory authority to define as an affiliate any investment fund—even if not an investment company for purposes of the 1940 Act—for which the member bank or an affiliate of the bank serves as an investment adviser, if the bank or an affiliate of the bank owns or controls more than 5 percent of any class of voting securities or similar interests of the fund.

Many investment funds that are advised by a member bank (or an affiliate of a member bank) are affiliates of the bank under section 23A because the funds either are investment companies under the 1940 Act or are sponsored by the member bank (or an affiliate of the member bank). The member bank or its affiliate, in some instances, however, may advise but not sponsor an investment fund that is not an investment company under the 1940 Act.[9] The advisory relationship of a member bank or affiliate with an investment fund presents the same potential for conflicts of interest regardless of whether the fund is an investment company under the 1940 Act.[10] The Dodd-Frank Act treats any investment fund as an affiliate if the bank or an affiliate of the bank serves as an investment adviser to the fund.

Financial Subsidiaries. In 1999, the Gramm-Leach-Bliley Act (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 amended section 23A to define a financial subsidiary of a bank as an affiliate of the bank and thus subjected covered transactions between the bank and a financial subsidiary to the limitations of sections 23A and 23B.

Section 23A defines a financial subsidiary as a subsidiary of any bank (state or national) that is engaged in an activity that is not permissible for national banks to engage in directly other than a subsidiary that federal law specifically authorizes national banks to own or control. Specifically, a "financial subsidiary" is defined 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."[11] Section 5136A, in turn, defines a financial subsidiary as any company that is controlled by one or more insured depository institutions (IDIs), other than (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly or (2) 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 small business investment company (SBIC).[12] (See 12 USC 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.[13] (See 12 USC 24a(a)(2)). Regulation W (1) defines a financial subsidiary of a bank, (2) exempts certain companies from the definition, and (3) sets forth special valuation and other rules for financial subsidiaries. (See sections 223.2(a)(8), 223.3(p), and 223.32 of the rule.)

Partnerships. Banks fund legitimate commercial transactions through partnerships. Partnerships for which a member bank or an affiliate serves as a general partner are affiliates.

Regulation W also defines an affiliate of a member bank as any partnership, if the member bank or an affiliate of the bank causes any director, officer, or employee of the bank or affiliate to serve as a general partner of the partnership (unless the partnership is an operating subsidiary of the bank). Also, if a company,

7. 12 USC 371c(b)(1)(D)(i).
8. 12 USC 371c(b)(1)(D)(ii).
9. 12 USC 371c(b)(1)(E).
10. An investment fund typically escapes from the definition of investment company under the 1940 Act because it (1) sells interests only to a limited number of investors or only to sophisticated investors or (2) invests primarily in financial instruments that are not securities. A member bank may face greater risk from the conflicts of interest arising from its relationships with an investment fund that is not registered than an investment company under the 1940 Act because the 1940 Act restricts transactions between a registered investment company and entities affiliated with the company's investment adviser. (See 15 USC 80a-17.)

11. 12 USC 24a(g)(3). (See also 12 USC 371c(e)(1)).
12. 12 USC 24a(a)(2).
13. 12 USC 371c(e)(1).

such as a bank holding company (BHC), controls more than 25 percent of the equity through a partnership, that company is an affiliate under Regulation W.

Subsidiaries of affiliates. Regulation W deems a subsidiary of an affiliate as an affiliate of the member bank.

Companies Designated by the Appropriate Federal Banking Agency

Under section 223.2(a)(12), the Board can determine that any company that has certain relationships with a member bank or an affiliate of the bank is itself an affiliate of the bank such that covered transactions by the bank with that company may be affected by the relationship to the detriment of the bank. The Board and the federal banking agencies can thus protect the member bank in their transactions with associated companies. A member bank may petition the Board for review of any such affiliate determination made by the institution's appropriate federal banking agency under the general procedures established by the Board for review of actions taken under delegated authority.[14]

Companies That Are Not Affiliates

Joint venture companies. Under section 223.2(b)(1)(iii) of the rule, certain joint venture subsidiary companies of a member bank are treated as affiliates. A subsidiary of a member bank is treated as an affiliate if one or more affiliates of the bank, or one or more controlling shareholders of the bank, directly control the joint venture. For example, if a bank controls 30 percent of Company A and an affiliate controls 70 percent of Company A, then Company A is an affiliate. This provision also covers situations in which a controlling natural-person shareholder or group of controlling natural-person shareholders of the member bank (who, as natural persons, are not themselves section 23A affiliates of the bank) exercise direct control over the joint venture company.

The rule's treatment of certain bank-affiliate joint ventures as affiliates does not apply to joint ventures between a member bank and any affiliated IDIs. For example, if two affiliated member banks each own 50 percent of the voting common shares of a company, the company would continue to qualify as a subsidiary and not an affiliate of each bank (despite the fact that an affiliate of each bank owned more than 25 percent of a class of voting securities of the company). The Board has retained its authority to treat such joint ventures as affiliates under section 23A on a case-by-case basis.

Employee benefit plans. Regulation W clarifies that under section 223.2(b)(1)(iv), an employee stock option plan (ESOP) of a member bank or an affiliate of the bank cannot itself avoid classification as an affiliate of the bank by also qualifying as a subsidiary of the bank. Many, but not all, ESOPs, trusts, or similar entities that exist to benefit shareholders, members, officers, directors, or employees of a member bank or its affiliates are treated as affiliates of the bank for purposes of sections 23A and 23B. The ESOP's share ownership or the interlocking management between the ESOP and its associated member bank (or BHC), in many cases, exceeds the statutory thresholds for determining that a company is an affiliate. For example, if an ESOP controls more than 25 percent of the voting shares of the bank or BHC, the ESOP is an affiliate.

The relationship between a member bank and its (or its) affiliate's ESOP generally warrants coverage by sections 23A and 23B. Member banks have made unsecured loans to their ESOPs or their affiliates or have guaranteed loans to such ESOPs that were made by a third party. These ESOPs, however, generally have no means to repay the loans other than with funds provided by the member bank. In addition, even if the ESOP's ownership does not warrant treatment as an affiliate, the issuance of holding company shares to an ESOP that is funded by a loan from the holding company's subsidiary bank could be used as a vehicle by the bank to provide funds to its parent company when the bank is unable to pay dividends or is otherwise restricted in providing funds to its holding company. The attribution rule (12 CFR 223.16) subjects such transactions to the restrictions of sections 23A and 23B.

14. See 12 CFR 265.3.

Determination of Control

Section 23A provides that a company or shareholder shall be deemed to have control over another company if, among other things, such company or shareholder controls in any manner the election of a majority of the "directors or trustees" of the other company.[15] The rule, under section 223.3(g), expands the control definition of section 23A by providing, as in Regulation Y, that control also exists when a company or shareholder controls the election of a majority of the "general partners (or individuals exercising similar functions)" of another company. A company or shareholder would be deemed to control another company (including a partnership, limited-liability company, or other similar organization) under section 23A if the company or shareholder controls the election of a majority of the principal policymakers of such other company.

Under Regulation W, the definition of "control" is similar, but not identical, to the definition used in the BHC Act. Under the rule, a company or shareholder shall be deemed to have control over another company if—

- such 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;
- such company or shareholder controls in any manner the election of a majority of the directors or trustees or general partners or individuals exercising similar functions of the other company; or
- the Board determines, after notice and opportunity for hearing, that such company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company.[16]

In addition, under the rule, three additional presumptions of control are provided, similar to the presumptions of control in Regulation Y. First, a company will be deemed to control securities, assets, or other ownership interests controlled by any subsidiary of the company.[17] Second, a company that controls instruments (including options and warrants) that are convertible or exercisable, at the option of the holder or owner, into securities, will be deemed to control the securities.[18] Third, a rebuttable presumption provides that 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 demonstrates otherwise to the Board based on the facts and circumstances of the particular case.[19] (See section 223.3(g).) Such a presumption of control is particularly appropriate in the section 23A context because a BHC may have incentives to divest the resources of a subsidiary bank to any company in which the holding company has a substantial financial interest, regardless of whether the holding company owns any voting securities of the company.

Section 23A and Regulation W provide that no company shall be deemed to own or control another company by virtue of its ownership or control of shares in a fiduciary capacity, except (1) a company that is controlled, directly or indirectly, by a trust for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, a member bank or (2) if the company owning or controlling such shares is a business trust.

Covered Transactions

The restrictions of section 23A do not apply to every transaction between a member bank and its affiliates.[20] The section only applies to seven "covered transactions" between a member bank and its affiliates.

A covered transaction under section 23A means

1. a loan or extension of credit to an affiliate, including a purchase of assets subject to an agreement to repurchase;
2. a purchase of or an investment in securities issued by an affiliate;
3. a member bank's purchase of assets from an

15. 12 USC 371c(b)(3)(A)(ii).
16. See 12 CFR 223.3(g) of the rule.
17. See 12 CFR 225.2(e)(2)(i).
18. See 12 CFR 225.31(d)(1)(i). The rule refers more generically to convertible "instruments." It clarifies that the convertibility presumption applies regardless of whether the right to convert resides in a financial instrument that technically qualifies as a "security" under section 23A or the federal securities laws.
19. See, for example, 12 CFR 225.144 and 225.145 (1982 and 2008 Board Policy Statements on Nonvoting Equity Investments).
20. 12 USC 371c(b)(7).

affiliate, except for purchases of real and personal property as may be specifically exempted by the Board by order or regulation;
4. the acceptance of securities or other debt obligations issued by an affiliate as collateral for a loan to any person or company;[21] or
5. the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.
6. a transaction with an affiliate that involves the borrowing or lending of securities to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate; or
7. a derivative transaction, as defined in 12 USC 84(b) with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.

If a transaction between a member bank and an affiliate is not within one of the above categories, it is not a covered transaction for the purposes of section 23A and is not subject to its limitations. All covered transactions must be conducted on terms and conditions that are consistent with safe and sound banking practices.[22]

Among the transactions that generally are not subject to section 23A are dividends paid by a member bank to its holding company, sales of assets by a member bank to an affiliate for cash, an affiliate's purchase of securities issued by a member bank, and many service contracts between a member bank and an affiliate. Certain classes of transactions between a member bank and an affiliate are discussed below as to whether they are covered transactions for purposes of section 23A. (See section 223.3(h).)

Attribution Rule

The "attribution rule," found in section 223.16, provides that any covered transaction by a member bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. For example, a member bank's loan to a customer for the purpose of purchasing securities from the inventory of a broker–dealer affiliate of the bank would be a covered transaction under section 23A.

Credit Transactions with an Affiliate

Extension of Credit to an Affiliate or Other Credit Transaction with an Affiliate

Section 23A includes a "loan or extension of credit" to an affiliate as a covered transaction but does not define these terms. Section 223.3(o) of the rule defines "extension of credit" to an affiliate to mean the making or renewal of a loan to an affiliate, the granting of a line of credit to an affiliate, or the extending of credit to an affiliate in any manner whatsoever, including on an intraday basis. A list of transactions are defined to be extensions of credit in the rule, but are not limited to the following transactions:

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[23]
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[24]

21. The acceptance of an affiliate's securities for a loan where the proceeds are transferred to, or used for the benefit of, an affiliate is prohibited.

22. Board staff has taken the position that safety and soundness requires the transaction be conducted on market terms.

23. The Board would consider a full-payout net lease permissible for a national bank under 12 USC 24 (seventh) and 12 CFR 23 to be the functional equivalent of an extension of credit.

24. A floating-rate loan does not become a new covered transaction whenever there is a change in the relevant index (for example, LIBOR or the member bank's prime rate) from which the loan's interest rate is calculated. If the member bank and the borrower, however, amend the loan agreement to change the interest-rate term from "LIBOR plus 100 basis points" to "LIBOR plus 150 basis points," the parties have engaged in a new covered transaction.

6. any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent) to a member bank[25]

A member bank's purchase of a debt security issued by an affiliate is an extension of credit by the bank to the affiliate for purposes of section 23A under the rule. A member bank that buys debt securities issued by an affiliate has made an extension of credit to an affiliate under section 23A and must collateralize the transaction in accordance with the collateral requirements of section 23A. An exemption from the collateral requirements is provided for situations in which a member bank purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction.

Issuance of a Guarantee or Letter of Credit

Confirmation of a Letter of Credit Issued by an Affiliate

Section 23A includes as a covered transaction the issuance by a member bank of a letter of credit on behalf of an affiliate, including the confirmation of a letter of credit issued by an affiliate as a covered transaction. See section 223.3(h)(5).[26] When a bank confirms a letter of credit, it assumes the risk of the underlying transaction to the same extent as if it had issued the letter of credit. Accordingly, a confirmation of a letter of credit issued by an affiliate is treated in the same fashion as an issuance of a letter of credit on behalf of an affiliate.

Credit Enhancements Supporting a Securities Underwriting

The definition of guarantee in section 23A does not include a member bank's issuance of a guarantee in support of securities issued by a third party and underwritten by a securities affiliate of the bank.[27] Such a credit enhancement would not be issued "on behalf of" the affiliate. Although the guarantee does provide some benefit to the affiliate (by facilitating the underwriting), this benefit is indirect. The proceeds of the guarantee would not be transferred to the affiliate for purposes of the attribution rule of section 23A.[28] Section 23B would apply to the transaction and, where an affiliate was issuer as well as underwriter, the transaction would be covered by section 23A because the credit enhancement would be on behalf of the affiliate.

Cross-Guarantee Agreements and Cross-Affiliate Netting Arrangements

A cross-guarantee agreement among a member bank, an affiliate, and a nonaffiliate in which the nonaffiliate may use the bank's assets to satisfy the obligations of a defaulting affiliate is a guarantee for purposes of section 23A. The cross-guarantee arrangements among member banks and their affiliates are subject to the quantitative limits and collateral requirements of section 23A. (See section 223.3(h)(5).)

As for cross-affiliate netting arrangements (CANAs), such arrangements involve a member bank, one or more affiliates of the bank, and one or more nonaffiliates of the bank, where 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. These arrangements also would include agreements in which a member 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.

These types of CANAs expose a member bank to the credit risk of its affiliates because the bank may become liable for the obligations of its affiliates. Because the exposure of a member bank to an affiliate in such an arrangement resembles closely the exposure of a member bank when it issues a guarantee on behalf of an affiliate, the rule explicitly includes such arrangements in the definition of covered transaction. Accordingly, the quantitative limits of section 23A would prohibit a member bank from entering into such a CANA to the extent that the netting arrangement does not cap the potential exposure of the bank to the participating affiliate (or affiliates).

25. The definition of extension of credit would cover, among other things, situations in which an affiliate fails to pay on a timely basis for services rendered to the affiliate by the member bank or fails to pay a tax refund to the member bank.
26. See UCC 5-107(2).
27. See 62 *Fed. Reg.* 45295 (August 27, 1997).
28. See 12 USC 371c(a)(2).

Keepwell Agreements

In a keepwell agreement between a member bank and an affiliate, the bank typically commits to maintain the capital levels or solvency of the affiliate. The credit risk incurred by the member bank in entering into such a keepwell agreement is similar to the credit risk incurred by a member bank in connection with issuing a guarantee on behalf of an affiliate. As a consequence, keepwell agreements generally should be treated as guarantees for purposes of section 23A and, if unlimited in amount, would be prohibited by the quantitative limits of section 23A.

Valuation of Credit Transactions with an Affiliate

A credit transaction between a member bank and an affiliate initially must be valued at the amount of funds provided by the member bank to, or on behalf of, the affiliate plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate. The section 23A value of a credit transaction between a member bank and an affiliate is the greater of (1) the principal amount of the credit transaction; (2) the amount owed by the affiliate to the member bank under the credit transaction; or (3) 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.

The first prong of the rule's valuation formula for credit transactions ("the principal amount of the credit transaction") would likely determine the valuation of a transaction in which a member bank purchased a zero-coupon note issued by an affiliate. A member bank should value such an extension of credit at the principal, or face, amount of the note (that is, at the amount that the affiliate ultimately must pay to the bank) rather than at the amount of funds initially advanced by the bank. For example, assume a member bank purchased from an affiliate for $50 a 10-year zero-coupon note issued by the affiliate with a face amount of $100. The rule's valuation formula requires the member bank to value this transaction at $100.

The second prong of the rule's valuation formula for credit transactions ("the amount owed by the affiliate") likely would determine the valuation of a transaction in which an affiliate fails to pay a member bank when due a fee for services rendered by the bank to the affiliate. This prong of the valuation formula does not include within section 23A's quantitative limits items such as accrued interest not yet due on a member bank's loan to an affiliate.

Member banks will be able to determine the section 23A value for most credit transactions under the third prong of the rule's valuation formula. Under this prong, for example, a $100 term loan is a $100 covered transaction, a $300 revolving credit facility is a $300 covered transaction (regardless of how much of the facility the affiliate has drawn down), and a guarantee backstopping a $500 debt issuance of the affiliate is a $500 covered transaction.

Under section 23A and the rule, a member bank has made an extension of credit to an affiliate if the bank purchases from a third party a loan previously made to an affiliate of the bank. A different valuation formula is provided for these indirect credit transactions. The member bank must value the transaction at the price paid by the bank for the loan plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate under the terms of the credit agreement.

For example, if a member bank pays a third party $90 for a $100 term loan that the third party previously made to an affiliate of the bank (because, for example, the loan was at a fixed rate and has declined in value because of a rise in the general level of interest rates), the covered transaction amount is $90 rather than $100. The lower covered-transaction amount reflects the fact that the member bank's maximum loss on the transaction is $90 rather than the original principal amount of the loan. For another example, if a member bank pays a third party $70 for a $100 line of credit to an affiliate, of which $70 had been drawn down by the affiliate, the covered-transaction amount would be $100 (the $70 purchase price paid by the bank for the credit plus the remaining $30 that the bank could be required to lend under the credit line).

In another example, a member bank makes a term 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.

Although the rule considers a member bank's purchase of, or investment in, a debt security issued by an affiliate as an extension of credit to an affiliate, these transactions are not valued like other extensions of credit. See section 223.23 for the valuation rules for purchases of, and investments in, the debt securities of an affiliate.

Timing of a Credit Transaction with an Affiliate

A member bank has entered into a credit transaction with an affiliate at the time during the day that the bank becomes legally obligated to make the extension of credit to, or issue the guarantee, acceptance, or letter of credit on behalf of, the affiliate. A covered transaction occurs at the moment that the member bank executes a legally valid, binding, and enforceable credit agreement or guarantee and does not occur only when a member bank funds a credit facility or makes payment on a guarantee. Consistent with section 23A, the rule only requires a member bank to compute compliance with its quantitative limits when the bank is about to engage in a new covered transaction. The rule does not require a member bank to compute compliance with the rule's quantitative limits on a continuous basis. See section 223.21(b)(1) of the rule.

The burden of the timing rule is significantly mitigated by the exemption for intraday extensions of credit found in section 223.42(l). The intraday credit exemption generally applies only to extensions of credit that a member bank expects to be repaid, sold, or terminated by the end of its U.S. business day. The bank must have policies and procedures to manage and minimize the credit exposure. Any such extension of credit that is outstanding at the end of the bank's business day must be treated as an extension of credit and must meet the regulatory quantitative and collateral requirements.

Asset Purchases from an Affiliate

Regulation W provides that a purchase of assets by a member bank from an affiliate initially must be valued at the total amount of consideration given by the bank in exchange for the asset. (See section 223.22.) This consideration can take any form and includes an assumption of liabilities by the member bank. Asset purchases are a covered transaction for a member bank for as long as the bank holds 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 generally accepted accounting principles (GAAP) and are reflected on the bank's financial statements.

Certain asset purchases by a member bank from an affiliate are not valued in accordance with the general asset-purchase valuation formula. First, if the member bank buys from one affiliate a loan to a second affiliate, the bank must value the transaction as a credit transaction with the second affiliate under section 223.21. Second, if the member bank buys from one affiliate a security issued by a second affiliate, the bank must value the transaction as an investment in securities issued by the second affiliate under section 223.23. Third, if the member bank acquires an affiliate that becomes an operating subsidiary of the bank after the acquisition, the bank must value the transaction under section 223.31.

A special valuation rule applies to a member bank's purchase of a line of credit or loan commitment from an affiliate. A member bank initially must value such asset purchases at the purchase price paid by the bank for the asset plus any additional amounts that the bank is obligated to provide under the credit facility.[29] This special valuation rule ensures that there are limits on the amount of risk a company can shift to an affiliated bank.

Section 23A(d)(6) provides an exemption for purchasing assets having a readily identifiable and publically available market quotation. Section 223.42(e) codifies this exemption. Section 223.42(f) of the rule expands the statutory (d)(6) exemption[30] to allow a member bank to purchase securities from an affiliate based on price quotes obtained from certain electronic services so long as, among other things, (1) the selling affiliate is a broker–dealer registered with the Securities and Exchange Commission (SEC), (2) the securities have a ready market and are eligible for purchase by state member banks, (3) the securities are not purchased within 30 days of an underwriting (if an affiliate of the

29. A member bank would not be required to include unfunded, but committed, amounts in the value of the covered transaction if (1) the credit facility being transferred from the affiliate to the bank is unconditionally cancelable (without cause) at any time by the bank and (2) the bank makes a separate credit decision before each drawing under the facility.

30. 12 USC 371c(d)(6).

bank is an underwriter of the securities), and (4) the securities are not issued by an affiliate.

In contrast with credit transactions, an asset purchase from a nonaffiliate that later becomes an affiliate generally does not become a covered transaction for the purchasing member bank. If a member bank purchases assets from a nonaffiliate in contemplation of the nonaffiliate's becoming an affiliate of the bank, however, the asset purchase becomes a covered transaction at the time the nonaffiliate becomes an affiliate. In addition, the member bank must ensure that the aggregate amount of the bank's covered transactions (including any such asset purchase from the nonaffiliate) would not exceed the quantitative limits of section 23A at the time the nonaffiliate becomes an affiliate.

The following examples are provided to assist member banks in valuing purchases of assets from an affiliate. A member bank's receipt of an encumbered asset from an affiliate ceases to be a covered transaction when, for example, the bank sells the asset.

- *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.
- *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, the transaction ceases to be a covered transaction at the time of the sale (regardless of the status of the mortgage).

Purchase of, and Investment in, Securities Issued by an Affiliate

Section 23A includes as a covered transaction a member bank's purchase of, or investment in, securities issued by an affiliate. Section 223.23 of the rule requires a member bank to value a purchase of, or investment in, securities issued by an affiliate (other than a financial subsidiary of the bank) at the greater of the bank's purchase price or carrying value of the securities.[31] A member bank that paid no consideration in exchange for affiliate securities has to value the covered transaction at no less than the bank's carrying value of the securities. In addition, if the member bank's carrying value of the affiliate securities increased or decreased after the bank's initial investment (due to profits or losses at the affiliate), the amount of the bank's covered transaction would increase or decrease to reflect the bank's changing financial exposure to the affiliate. However, the amount of the bank's covered transaction cannot decline below the amount paid by the bank for the securities.

Several important considerations support the general carrying-value approach of this valuation rule. First, the approach is consistent with GAAP, which would require a 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 member bank's continuing exposure to an affiliate through an ongoing investment in the affiliate's securities.

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 valuation rule requires a member bank to revalue upwards the amount of an investment in affiliate securities only when the bank's exposure to the affiliate increases (as reflected on the bank's financial statements) and the bank's capital increases to reflect the higher value of the

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

investment. In these circumstances, the valuation rule merely reflects the member bank's greater financial exposure to the affiliate and enhances 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.

The valuation rule also provides that the covered-transaction amount of a member 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 the purchase price. Although this aspect of the valuation rule is not consistent with GAAP, using the member bank's purchase price for the securities as a floor for valuing the covered transaction is appropriate. First, it ensures that the amount of the covered transaction never falls below the amount of funds actually transferred by the member bank to the affiliate in connection with the investment. In addition, the purchase-price floor limits the ability of a member bank to provide additional funding to an affiliate as the affiliate approaches insolvency. If investments in securities issued by an affiliate were valued strictly at carrying value, then the member bank could lend more funds to the affiliate as the affiliate's financial condition worsened. As the affiliate declined, the member 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 what section 23A was intended to restrict.

The examples provided below are designed to assist member banks in valuing purchases of, and investments in, securities issued by an affiliate.

- *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.
- *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.
- *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.

Extensions of Credit Secured by Affiliates' Securities

Extensions of Credit—General Valuation Rule (Section 223.24(a) and (b))

Section 23A defines as a covered transaction a member bank's acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company. This type of covered transaction has two classes: one in which the only collateral for the loan is solely affiliate securities and another in which the loan is secured by a combination of affiliate securities and other collateral.[32]

Extensions of Credit Secured by Mutual Fund Shares

Section 23A(b)(7)(D) of the FRA defines as a covered transaction a member bank's acceptance of securities issued by an affiliate as collateral security for a loan or extension of credit to any person or company.[33]

32. The securities issued by an affiliate cannot be used as collateral for a loan to any affiliate (12 USC 371c (c)(4).

33. See 12 USC 371c(b)(7)(D). This covered transaction only arises when the member bank's loan is to a nonaffiliate. Under section 23A, the securities issued by an affiliate are not acceptable collateral for a loan or extension of credit to any affiliate. See 12 USC 371c(c)(4). If the proceeds of a loan that is secured by an affiliate's securities are transferred to an

Section 223.24(c) of the rule provides an exemption for extensions of credit by a member bank that are secured by shares of an affiliated mutual fund. To qualify for the exemption, the transaction must meet several conditions. 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 1940 Act. Second, to ensure that the member bank can easily establish and monitor the value of the affiliate collateral, the affiliated mutual fund's shares serving as collateral for the extension of credit must have a publicly available market price. Third, to reduce the member bank's incentives to use these extensions of credit as a mechanism to support the affiliated mutual fund, the member 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 affiliated mutual fund's shares serving as collateral or otherwise used to benefit an affiliate. In such circumstances, the member bank's extension of credit would be covered by section 23A's attribution rule. For example, 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 section 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 section 223.14, the loan would not be in compliance with section 223.14.

Under the rule, if the credit extension is secured exclusively by affiliate securities, then the transaction is valued at the full amount of the extension of credit. This approach reflects the difficulty of measuring the actual value of typically untraded and illiquid affiliate securities and conservatively assumes that the value of the securities is equal to the full value of the loan that the securities collateralize. An exception is provided to the general rule when the affiliate securities held as collateral have a ready market (as defined by section 223.42 of the rule). In that case, the transaction may be valued at the fair market value of the affiliate securities. The exception grants relief in those circumstances when the value of the affiliate securities is independently verifiable by reference to transactions occurring in a liquid market.[34]

Covered transactions of the second type, in which the credit extension is secured by affiliate securities and other collateral, are valued at the lesser of (1) the total value of the extension of credit minus the fair market value of the other collateral or (2) the fair market value of the affiliate securities (if the securities have a ready market). The rule's ready-market requirement applies regardless of the amount of affiliate collateral.[35]

A Member Bank's Acquisition of an Affiliate That Becomes an Operating Subsidiary

Section 223.31 (a)–(c) of the rule provides guidance to a member bank that acquires an affiliate. The first situation is when a member bank directly purchases or otherwise acquires the affiliate's assets and assumes the affiliate's liabilities. In this case, the transaction is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any separate consideration paid by the member bank for the affiliate's assets (if any), plus the amount of any liabilities assumed by the bank in the transaction.

The rule provides that the acquisition by a member bank of a company that was an affiliate of the 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 bank and (2) the company has liabilities, or the bank gives cash or any other consideration in exchange for the securities. The rule also provides that these

affiliate by the unaffiliated borrower (for example, to purchase assets or securities from the inventory of an affiliate), the loan should be treated as a loan to the affiliate, and the affiliate's securities cannot be used to meet the collateral requirements of sections 23A. The loan must then be secured with other collateral in an amount and of a type that meets the requirements of section 23A for loans by a member bank to an affiliate.

34. In either case, the transaction must comply with section 23B; that is, the member bank must obtain the same amount of affiliate securities as collateral on the credit extension that the bank would obtain if the collateral were not affiliate securities.

35. Under the rule, a member bank may use the higher of the two valuation options for these transactions if, for example, the bank does not have the procedures and systems in place to verify the fair market value of affiliate securities.

transactions must be valued initially at the sum of (1) the total amount of consideration given by the member bank in exchange for the securities and (2) the total liabilities of the company whose securities have been acquired by the member bank. In effect, the rule requires member banks to treat such share donations and purchases in the same manner as if the member bank had purchased the assets of the transferred company at a purchase price equal to the liabilities of the transferred company (plus any separate consideration paid by the bank for the shares). (See 12 CFR 223.31.)

Similarly, when an affiliate donates a controlling block of an affiliate's shares to a member bank, a covered transaction occurs if the affiliate has liabilities that the member bank assumes. For example, the parent holding company of a member bank contributes between 25 percent 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 section 223.31. 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. However, if the member bank 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.

Another situation is when a member bank acquires an affiliate by merger. Because a merger with an affiliate generally results in the member bank's acquiring all the assets of the affiliate and assuming all the liabilities of the affiliate, this transaction is effectively equivalent to the purchase and assumption transaction described in the previous paragraph. Accordingly, the merger transaction also is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any consideration paid by the member bank for the affiliate's assets (if any), plus the amount of any liabilities assumed by the bank in the transaction.[36]

The assets and liabilities of an operating subsidiary of a member bank are treated in the rule as assets and liabilities of the bank itself for purposes of section 23A.[37] The rule only imposes asset-purchase treatment on affiliate share transfers when the company whose shares are being transferred to the member bank was an affiliate of the bank before the transfer. If the transferred company was not an affiliate before the transfer, it would not be appropriate to treat the share transfer as a purchase of assets from an affiliate. Similarly, the rule only requires asset-purchase treatment for affiliate share transfers when the transferred company becomes a subsidiary and not an affiliate of the member bank through the transfer.

If a member bank purchases, or receives a donation, of a partial interest in an entity that remains an affiliate, that transaction is treated as a purchase of, or investment in, securities issued by an affiliate. This type of transaction is valued according to the purchase price or GAAP carrying value. (See 12 CFR 223.23.)

Step-Transaction Exemption (Section 223.31(d) and (e))

Under section 223.31(d) of the rule, an exemption is provided for certain step transactions that are treated as asset purchases under section 223.31(a) when an affiliate owned the transferred company for a limited period of time. Regulation W provides an exemption when a company acquires the stock of an unaffiliated company and, immediately after consummation of the acquisition, transfers the shares of the acquired company to the holding company's

36. As noted, section 223.3(dd) of the rule makes explicit the Board's view that these merger transactions generally involve the purchase of assets by a member bank from an affiliate.

37. Because a member bank usually can merge a subsidiary into itself, transferring all the shares of an affiliate to a member bank often is functionally equivalent to a transaction in which the bank directly acquires the assets and assumes the liabilities of the affiliate. In a direct acquisition of assets and assumption of liabilities, the covered transaction amount would be equal to the total amount of liabilities assumed by the member bank.

subsidiary member bank. For example, a BHC 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 section 223.31, would qualify for the exemption in paragraph (d) of section 223.31.

The rule exempts these "step" transactions under certain conditions. First, the member bank must acquire the target company immediately after the company became an affiliate (by being acquired by the bank's holding company, for example).[38] The member bank must acquire the entire ownership position in the target company that its holding company acquired. Also, there must be no material change in the business or financial condition of the target company during the time between when the company becomes an affiliate of the member bank and when the bank is in receipt of the company. Finally, the entire transaction must comply with the market-terms requirement of section 23B, and the bank must notify its appropriate federal banking agency and the Board, at or before the time that the target company becomes an affiliate of the bank, of its intent ultimately to acquire the target company.

Regulation W requires that the bank consummate the step transaction immediately to ensure the quality and fairness of the transaction. To the extent that the member bank acquires the target company some time after the company becomes an affiliate, the transaction looks less like a single transaction in which the bank acquires the target company and more like two separate transactions, the latter of which involves the bank acquiring assets from an affiliate.

The Board recognized, however, that banking organizations may need a reasonable amount of time to address legal, tax, and business issues relating to an acquisition. Regulation W thus permits member banks to avail themselves of the step-transaction exemption if the bank acquires the target company within three months after the target company becomes an affiliate so long as the appropriate federal banking agency for the bank has approved the longer time period.

The 100 percent ownership requirement (that the member bank must acquire the entire ownership position in the target company that its holding company acquired) prevents a holding company from keeping the good assets of the target company and transferring the bad assets to the holding company's subsidiary member bank. If a banking organization fails to meet the terms of the step-transaction exemption, the organization may be able to satisfy the conditions of the rule's internal-corporate-reorganization exemption or may be able to obtain a case-by-case exemption from the Board.

Prohibition on the Purchase of Low-Quality Assets

Section 23A generally prohibits the purchase by a member bank of a low-quality asset from an affiliate.[39] In addition, a member bank cannot purchase or accept as collateral a low-quality asset from an affiliate. Section 23A defines a low-quality asset to include (1) an asset classified as "substandard," "doubtful," or "loss," or treated as "other loans specially mentioned," in the most recent report of examination or inspection by a federal or state supervisory agency (a "classified asset"); (2) an asset in nonaccrual status; (3) an asset on which payments are more than 30 days past due; or (4) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.[40] Any asset meeting one of the above four criteria, including securities and real

38. This exemption can be used only by BHCs that are in existence at the time of the transaction. A BHC in formation cannot take advantage of the exemption. For example, a leasing company that applies to become a BHC cannot use the exemption to transfer its leasing assets to the bank.

39. 12 USC 371c(a)(3). Section 23A does not prohibit an affiliate from donating a low-quality asset to a member bank, so long as the bank provides no consideration for the asset, and no liabilities are associated with the asset.

40. 12 USC 371c(b)(10).

property, is a low-quality asset.[41]

Regulation W expands the definition of low-quality assets in several respects. (See 12 CFR 223.3(v).) First, an asset is identified by examiners as a low-quality asset if they represent credits to countries that are not complying with their external debt-service obligations but are taking positive steps to restore debt service through economic adjustment measures, generally as part of an International Monetary Fund program. Although such assets may not be considered classified assets, examiners are to consider these assets in their assessment of a bank's asset quality and capital adequacy. See also section 7040.3 and SR-08-12.

Second, the rule considers a financial institution's use of its own internal asset-classification systems. The rule includes within the definition of low-quality asset not only assets classified during the last examination but also assets classified or treated as special mention under the institution's internal classification system (or assets that received an internal rating that is substantially equivalent to classified or special mention in such an internal system).

The purchase by a depository institution from an affiliate of assets that have been internally classified raises potentially significant safety-and-soundness concerns. The Board expects companies with internal rating systems to use the systems consistently over time and over similar classes of assets and will view as an evasion of section 23A any company's deferral or alteration of an asset's rating to facilitate sale of the asset to an affiliated institution.

Finally, the rule defines low-quality asset to include foreclosed property designated "other real estate owned" (OREO), until it is reviewed by an examiner and receives a favorable rating. It further defines as a low-quality asset any asset (not just real estate) that is acquired in satisfaction of a debt previously contracted (not just through foreclosure) if the asset has not yet been reviewed in an examination or inspection. Under the rule, if a particular asset is good collateral taken from a bad borrower, the asset should cease to be a low-quality asset upon examination.

Section 23A provides a limited exception to the general rule prohibiting purchase of low-quality assets if the bank performs an independent credit evaluation and commits to the purchase of the asset before the affiliate acquires the asset.[42] Section 223.15 of the rule also provides an exception from the prohibition on the purchase by a member bank of a low-quality asset from an affiliate for certain loan renewals. The rule allows a member bank that purchased a loan participation from an affiliate to renew its participation in the loan, or provide additional funding under the existing participation, even if the underlying loan had become a low-quality asset, so long as certain criteria were met. These renewals or additional credit extensions may enable both the affiliate and the participating member bank to avoid or minimize potential losses. The exception is available only if (1) the underlying loan was not a low-quality asset at the time the member bank purchased its participation and (2) the proposed transaction would not increase the member bank's proportional share of the credit facility. The member bank must also obtain the prior approval of its entire board of directors (or its delegees) and it must give a 20-days' post-consummation notice to its appropriate federal banking agency. A member bank is permitted to increase its proportionate share in a restructured loan by 5 percent (or by a higher percentage with the prior approval of the bank's appropriate federal banking agency). The scope of the exemption includes renewals of participations in loans originated by any affiliate of the member bank (not just affiliated depository institutions).

Financial Subsidiaries

Section 23A Statutory Provisions for Financial Subsidiaries

Section 23A has several special provisions that apply to covered transactions between a bank and its financial subsidiary. 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

41. The federal banking agencies generally consider non-investment-grade securities to be classified assets. See, for example, the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks (May 7, 1979) and also table 3 in section 2020.1 of this manual. Assets identified by examiners through the Shared National Credit and Interagency Country Exposure Review Committee processes also should be considered classified assets for purposes of section 23A.

42. 12 USC 371c(a)(3).

States.[43] Section 5136A, in turn, defines a financial subsidiary of a national bank as any company that is controlled by one or more IDIs, other than (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly (and subject to the same terms and conditions that apply to national banks) or (2) a national bank that is specifically authorized by the express terms of a federal statute (other than section 5136A), such as an Edge Act corporation or an SBIC.[44] Section 5136A also prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities.[45]

The Dodd-Frank Act amended section 23A as it relates to financial subsidiaries of a bank. First, the 10 percent quantitative limit of section 23A between a bank and any individual affiliate now applies to covered transactions between a bank and any individual financial subsidiary of the bank. In addition, for purposes of section 23A, the amount of a bank's investment in its financial subsidiary includes the retained earnings of the financial subsidiary. See section 609(a) of the Dodd-Frank Act.

Section 23A generally applies only to transactions between (1) a bank and an affiliate of the bank and (2) a bank and a third party in which some benefit from either type of transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. Section 23A establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a bank and another affiliate of the bank. First, the FRA provides that any purchase of, or investment in, the securities of a bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem a loan or other extensions of credit made by a bank's affiliate to any financial subsidiary of a bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasion.

43. 12 USC 24a(g)(3).
44. 12 USC 24a(2).
45. 12 USC 371c(c)(1).

Regulation W Provisions for Financial Subsidiaries

Regulation W (1) defines a financial subsidiary of a bank, (2) exempts certain companies from the definition, and (3) sets forth special valuation and other rules for financial subsidiaries. (See sections 223.3(a)(8), 223.3(p), and 223.32 of the rule.) In section 223.32, Regulation W also includes, several special rules that apply to transactions for financial subsidiaries.

Applicability of the 10 percent quantitative limit to transactions with a financial subsidiary. The 10 percent quantitative limit in section 23A applies with respect to covered transactions between a member bank and any individual financial subsidiary of the bank.

Valuation of investments in securities issued by a financial subsidiary. Because financial subsidiaries of a member bank are considered affiliates of the bank for purposes of section 23A, a member bank's purchases of, and investments in, the securities of its financial subsidiary are covered transactions under the statute. The Dodd-Frank Act further provides that a member bank's investment in its own financial subsidiary, for purposes of section 23A, shall include the retained earnings of the financial subsidiary. In light of this statutory provision, section 223.32(b) of Regulation W contains a special valuation rule for investments by a member bank in the securities of its own financial subsidiary.[46] Such investments must be valued at the greater of (1) the price paid by the member bank for the securities or (2) the carrying value of the securities on the financial statements of the member bank (determined in accordance with GAAP but without reflecting the bank's pro rata share of any earnings retained or losses incurred by the financial subsidiary after the bank's acquisition of the securities).[47]

46. The rule's special valuation formula for investments by a member bank in its own financial subsidiary does not apply to investments by a member bank in a financial subsidiary of an affiliated depository institution. Such investments must be valued using the general valuation formula set forth in section 223.23 for investments in securities issued by an affiliate and, further, may trigger the anti-evasion rule contained in section 223.32(c)(1) of the rule.

47. The rule also makes clear that if a financial subsidiary is consolidated with its parent member bank under GAAP, the carrying value of the bank's investment in the financial subsidiary shall be determined based on parent-only financial statements of the bank.

The following examples were designed to assist banks in valuing investments in securities issued by a financial subsidiary of the bank. Each example involves a securities underwriter that becomes a financial subsidiary of the bank after the transactions described below.

Initial valuation.

- *Direct acquisition by a bank.* A 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.
- *Contribution of a financial subsidiary to a bank.* 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 bank initially must value the investment at the carrying value of the shares on the bank's parent-only GAAP financial statements. Under GAAP, the bank's initial carrying value of the shares would be $500.

Anti-evasion rules as they pertain to financial subsidiaries. Section 23A generally applies only to transactions between a bank and an affiliate of the bank and transactions between a member bank and a third party when some benefit of the transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. The GLB Act establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a member bank and another affiliate of the bank.[48] First, the GLB Act provides that any purchase of, or investment in, securities issued by a member bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem an extension of credit made by a member bank's affiliate to any financial subsidiary of the bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasions of the FRA or the GLB Act. Section 223.32(c) of the rule incorporates both of these provisions.

The Board exercised its authority under the second anti-evasion rule by stating that an 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 itself to the financial subsidiary if the extension of credit is treated as regulatory capital of the financial subsidiary. An example of the kind of credit extension covered by this provision would be a subordinated loan to a financial subsidiary that is a securities broker–dealer where the loan is treated as capital of the subsidiary under the SEC's net capital rules. Treating such an extension of credit as a covered transaction is appropriate because the extension of credit by the affiliate has a similar effect on the subsidiary's regulatory capital as an equity investment by the affiliate, which is treated as a covered transaction by the terms of the GLB Act (as described above). The rule generally does not prevent a BHC or other affiliate of a member bank from providing financial support to a financial subsidiary of the bank in the form of a senior or secured loan.

48. GLB Act section 121(b)(1), codified at 12 USC 371c(e)(4)).

Collateral for Certain Transactions with Affiliates

Section 23A(c) requires a member bank's use of collateral for certain transactions between a member bank and its affiliates.[49] Each loan or extension of credit to an affiliate[50] or guarantee, acceptance, or letter of credit issued on behalf of an affiliate (herein referred to as credit transactions) by a member bank or its subsidiary, and any credit exposure of a member bank or a subsidiary to an affiliate resulting from a securities borrowing or lending transaction, or a derivatives transaction shall be secured at all times by collateral ("credit exposure") at the amounts required by the statute. The required collateral varies[51] depending on the type of collateral used to secure the transaction.[52]

49. The bank must perfect the security interest in the collateral (*Fitzpatrick v. FDIC*, 765 F.2d 569 (6th Cir. 1985)). A purchase of assets from an affiliate does not require collateral.

50. 12 USC 371c(b)(7).

51. "Credit extended" means the loan or extension of credit, guarantee, acceptance, or letter of credit.

52. 12 USC 371c(c)(1).

The specific collateral requirements are—

1. 100 percent of the amount of such loan or extension of credit, guarantee, acceptance, letter of credit or credit exposure, if the collateral is composed of
   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 banker's acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank;[53] or
   d. a segregated, earmarked deposit account with the member bank that is for the sole purpose of securing a credit transaction between the member bank and its affiliates and is identified as such;
2. 110 percent of the amount of the credit extended if the collateral is composed of obligations of any state or political subdivision of any state;
3. 120 percent of the amount of the credit extended if the collateral is composed of other debt instruments, including receivables; or
4. 130 percent of the amount of the credit extended if the collateral is composed of stock, leases, or other real or personal property.

For 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. The statute prohibits a member bank from counting a low-quality asset toward section 23A's collateral requirements for credit transactions with affiliates.[54] A member bank must maintain a perfected security interest at all times in the collateral that secures the credit transaction.

Section 23A(c)(1) requires that credit transactions must meet the collateral requirements of the statute at all times. A low-quality asset cannot be used to satisfy the statute or the regulation's collateral requirements, but can be taken as additional collateral.

Collateral Requirements in Regulation W

The collateral requirements for credit transactions are found in section 223.14 of Regulation W.

Deposit Account Collateral. Under section 23A, a member bank may satisfy the collateral requirements of the statute by securing a credit transaction with an affiliate with a "segregated, earmarked deposit account" maintained with the bank in an amount equal to 100 percent of the credit extended.[55]

Member banks may secure covered transactions with omnibus deposit accounts so long as the member bank takes steps to ensure that the omnibus deposit accounts fully secure the relevant covered transactions. Such steps might include substantial overcollateralization or the use of subaccounts or other recordkeeping devices to match deposits with covered transactions. To obtain full credit for any deposit accounts taken as section 23A collateral, member banks must ensure that they have a perfected, first-priority security interest in the accounts. (See section 223.14(b)(1)(i)(D).)

Ineligible collateral. The purpose of section 23A's collateral requirements is to ensure that member banks that engage in credit transactions with affiliates have legal recourse, in the event of affiliate default, to tangible assets with a value at least equal to the amount of the credit extended.

The statute recognizes that certain types of assets are not appropriate to serve as collateral for credit transactions with an affiliate. In particular, the statute provides that low-quality assets and securities or other debt obligations issued by an affiliate are not eligible collateral for such covered transactions.[56]

Under section 223.14(c) of the rule, intangible assets also are not deemed acceptable to meet the collateral requirements imposed by

53. Regulation A includes a representative list of acceptable government obligations (12 CFR 201.108).
54. 12 USC 371c(c)(3).
55. 12 USC 371c(c)(1)(A)(iv).
56. 12 USC 371c (c)(3) and (4).

section 23A.[57] Intangible assets, including servicing assets, are particularly hard to value, and a member bank may have significant difficulty in collecting and selling such assets in a reasonable period of time.

Section 23A(c) requires that credit transactions with an affiliate be "secured" by collateral. A credit transaction between a member bank and an affiliate supported only by a guarantee or letter of credit from a third party does not meet the statutory requirement that the credit transaction be secured by collateral. Guarantees and letters of credit often are subject to material adverse change clauses and other covenants that allow the issuer of the guarantee or letter of credit to deny coverage. Letters of credit and guarantees are not balance-sheet assets under GAAP and, accordingly, would not constitute "real or personal property" under section 23A. There is a particularly significant risk that a member bank may have difficulty collecting on a guarantee or letter of credit provided by a nonaffiliate on behalf of an affiliate of the bank. Accordingly, guarantees and letters of credit are not acceptable section 23A collateral.[58]

As noted above, section 23A prohibits a member bank from accepting securities or other debt obligations issued by an affiliate as collateral for an extension of credit to any affiliate. The rule clarifies that securities issued by the member bank itself also are not eligible collateral to secure a credit transaction with an affiliate. Equity securities issued by a lending member bank, and debt securities issued by a lending member bank that count as regulatory capital of the bank, are not eligible collateral under section 23A. If a member bank were forced to foreclose on a credit transaction with an affiliate secured by such securities, the bank may be unwilling to liquidate the collateral promptly to recover on the credit transaction because the sale might depress the price of the bank's outstanding securities or result in a change in control of the bank. In addition, to the extent that a member bank is unable or unwilling to sell such securities acquired through foreclosure, the transaction would likely result in a reduction in the bank's capital, thereby offsetting any potential benefit provided by the collateral.

Perfection and priority. Under section 223.14(d) of the rule, a member bank's security interest in any collateral required by section 23A must be perfected in accordance with applicable law to ensure that a member bank has good access to the assets serving as collateral for its credit transactions with affiliates. This requirement ensures that the member bank has the legal right to realize on the collateral in the case of default, including a default resulting from the affiliate's insolvency or liquidation. A member bank also is required to either obtain a first-priority security interest in the required collateral or deduct from the amount of collateral obtained by the bank the lesser of (1) the amount of any security interests in the collateral that are senior to that obtained by the bank or (2) the amount of any credits secured by the collateral that are senior to that of the bank. For example, if a member bank lends $100 to an affiliate and takes as collateral a second lien on a parcel of real estate worth $200, the arrangement would only satisfy the collateral requirements of section 23A if the affiliate owed the holder of the first lien $70 or less (a credit transaction secured by real estate must be secured at 130 percent of the amount of the transaction).

The rule includes the following example of how to compute the section 23A collateral value of a junior lien: 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. Because of 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).

Unused portion of an extension of credit. Section 23A requires that the "amount" of an extension of credit be secured by the statutorily prescribed levels of collateral. Under the statute, if a member bank provides a line of credit to an affiliate, it must secure the full amount of the

57. The rule does not confine the definition of intangible assets by reference to GAAP.

58. The rule also provides that instruments "similar" to guarantees and letters of credit are ineligible collateral. For example, in the Board's view, a member bank cannot satisfy section 23A's collateral requirements by purchasing credit protection in the form of a credit-default swap referencing the affiliate's obligation.

line of credit throughout the life of the credit. Section 223.14(f)(2) of the rule, however, provides an exemption to the collateral requirements of section 23A for the unused portion of an extension of credit to an affiliate so long as the member bank does not have any legal obligation to advance additional funds under the credit facility until the affiliate has posted the amount of collateral required by the statute with respect to the entire used portion of the extension of credit.[59] In such credit arrangements, securing the unused portion of the credit line is unnecessary from a safety-and-soundness perspective because the affiliate cannot require the member bank to advance additional funds without posting the additional collateral required by section 23A. If a member bank voluntarily advances additional funds under such a credit arrangement without obtaining the additional collateral required under section 23A to secure the entire used amount (despite its lack of a legal obligation to make such an advance), the Board views this action as a violation of the collateral requirements of the statute. The entire amount of the line of credit counts against the bank's quantitative limit, even if the line does not need to be secured.

Purchasing affiliate debt securities in the secondary market. A member bank's investment in the debt securities issued by an affiliate is an extension of credit by the bank to the affiliate and thus is subject to section 23A's collateral requirements. Section 223.14(f)(3) of the rule provides an exemption that permits member banks in certain circumstances to purchase debt securities issued by an affiliate without satisfying the collateral requirements of section 23A. The exemption is available where a member bank purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction. When a member bank buys an affiliate's debt securities in a bona fide secondary-market transaction, the risk that the purchase is designed to shore up an ailing affiliate is reduced. Any purchase of affiliate debt securities that qualifies for this exemption would still remain subject to the quantitative limits of section 23A and the market-terms requirement of section 23B. In analyzing a member bank's good faith under this exemption transaction, examiners should look at the time elapsed between the original issuance of the affiliate's debt securities and the bank's purchase, the existence of any relevant agreements or relationships between the bank and the third-party seller of the affiliate's debt securities, any history of bank financing of the affiliate, and any other relevant information.

Credit transactions with nonaffiliates that become affiliates. Banks sometimes lend money to, or issue guarantees on behalf of, unaffiliated companies that later become affiliates of the bank. Section 223.21(b)(2) provides transition rules that exempt credit transactions from the collateral requirements in situations in which the member bank entered into the transactions with the nonaffiliate at least one year before the nonaffiliate became an affiliate of the bank.

For example, 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 the rule's section 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. The transaction counts towards the 20 percent limit for transactions for all affiliates. In addition, the member bank must bring the loan into compliance with the collateral requirements of section 223.14 promptly after the stock acquisition. Transactions with nonaffiliates in contemplation of the nonaffiliate becoming an affiliate must meet the quantitative and collateral requirements of the rule at the time of the inception of the credit transaction and of the affiliation.

Limitations on Collateral

Member banks may accept as collateral for covered transactions receivables, leases, or other

59. This does not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate. These instruments must be fully collateralized at inception. Moreover, the transaction is still subject to the 10 and 20 percent limits of the statute.

real or personal property.[60] The following are limitations and collateral restrictions:

1. A low-quality asset is not acceptable as collateral for a loan or extension of credit to, or for a guarantee, acceptance, or letter of credit issued on behalf of, an affiliate or credit exposure to an affiliate resulting from a secured borrowing or lending transaction or derivative transaction.
2. Securities or other debt obligations issued by an affiliate of a member bank shall not be acceptable as collateral for a loan or extension of credit to, or for a guarantee, acceptance, or letter of credit issued on behalf of, or credit exposure from a securities borrowing or lending transaction or derivatives transaction to, that affiliate or any other affiliate of the member bank. The above collateral requirements are not applicable to an acceptance that is already fully secured either by attached documents or by other property that is involved in the transaction and has an ascertainable market value.

Derivative Transactions Between Insured Depository Institutions and Their Affiliates

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 member 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 BHC may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The BHC 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 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.

Section 23A on Derivative Transactions

The Dodd-Frank Act provides that the credit exposure resulting from a derivative transaction with an affiliate is a covered transaction (12 USC 371c(b)(7)(G)). In addition, Regulation W requires the member bank to establish and maintain policies and procedures designed to manage the credit exposure arising from the derivative. These policies and procedures require, at a minimum, that the bank monitor and control its exposure to its affiliates by imposing appropriate credit controls and collateral requirements.

Regulation W provides that credit derivatives between an institution and an unaffiliated third party that reference the obligations of an affiliate of the institution, and that are the functional equivalent of a guarantee by the institution on behalf of an affiliate, should be treated as a guarantee by the institution on behalf of an affiliate for the purposes of section 23A.[61]

Section 23B and Regulation W Regarding Derivative Transactions

Derivative transactions between a member bank and an affiliate also are subject to section 23B of the FRA under the express terms of the statute.[62]

60. As noted above, letters of credit and mortgage servicing rights may not be accepted as collateral for purposes of section 23A. See 12 CFR 223.14(c)(4) and (5).

61. The novation of a derivative between a bank and its affiliate is treated as a purchase of assets under the statute.

62. In addition to applying to covered transactions, as defined in section 23A of the FRA, the market-terms requirement of section 23B of the FRA applies broadly to, among other things, "[t]he payment of money or the furnishing of services to an affiliate under contract, lease or otherwise" (12

In this regard, section 23B requires a member bank to treat an affiliate no better than a *similarly situated* nonaffiliate. Section 23B generally does not allow a member bank to use with an affiliate the terms and conditions it uses with its most creditworthy unaffiliated customer, unless the bank can demonstrate that the affiliate is of comparable creditworthiness as the bank's most creditworthy unaffiliated customer. Instead, section 23B requires that an affiliate be treated comparably (with respect to terms, conditions, and credit limits) to the majority of third-party customers engaged in the same business, and having comparable credit quality and size as the affiliate. Because a bank generally has the strongest credit rating within a holding company, the Board generally would not expect an affiliate to obtain better terms and conditions from a member bank than the member bank receives from its major unaffiliated counterparties. In addition, market terms for derivatives among major financial institutions generally include daily marks to market and two-way collateralization above a relatively small exposure threshold.

Covering Derivatives That Are the Functional Equivalent of a Guarantee

Section 223.33 of the rule provides that credit derivatives between a member bank and a nonaffiliate in which the bank protects the nonaffiliate from a default on, or a decline in the value of, an obligation of an affiliate of the bank are covered transactions under section 23A. Such derivative transactions are viewed as guarantees by a member bank on behalf of an affiliate (and, hence, are covered transactions) under section 23A.

The rule provides that these credit derivatives are covered transactions under section 23A and gives several examples.[63] A member bank is not allowed to reduce its covered-transaction amount for these derivatives to reflect hedging positions established by the bank with third parties. A credit derivative is treated as a covered transaction only to the extent that the derivative provides credit protection with respect to obligations of an affiliate of the member bank.

USC 371c-1(a)(2)(C)). Institution-affiliate derivatives generally involve a contract or agreement to pay money to the affiliate or furnish risk-management services to the affiliate.

63. This does not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate. These instruments must be fully collateralized at inception. In most instances, the covered-transaction amount for such a credit derivative would be the notional principal amount of the derivative.

Exemptions from Section 23A

Section 23A exempts seven transactions or relations from its quantitative limits and collateral requirements.[64] Regulation W, subpart E, clarifies certain of these exemptions and exempts a number of additional types of transactions.

The Board reserves the right to revoke or modify any additional exemption granted by the Board in Regulation W, if the Board finds that the exemption is resulting in unsafe or unsound banking practices. The Board also reserves the right to terminate the eligibility of a particular member bank to use any such exemption if the bank's use of the exemption is resulting in unsafe or unsound banking practices.

Covered Transactions Exempt from the Quantitative Limits and Collateral Requirements

Under the rule's section 223.41, the quantitative limits (sections 223.11 and 223.12) and the collateral requirements (section 223.14) do not apply to the following transactions. The transactions are, however, subject to the safety-and-soundness requirement (section 223.13) and the prohibition on the purchase of a low-quality asset (section 223.15).

- *Parent institution/subsidiary institution transactions.* 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.
- *Purchase of loans on a nonrecourse basis from an affiliated depository institution.* Banks that are commonly controlled (i.e., at least 25 percent common ownership) can purchase loans on a nonrecourse basis. This allows chain banks and banks in companies that are not owned 80 percent by the same company to achieve the same efficiency as sister banks.

64. 12 USC 371c(d).

Sister-bank exemption (section 223.41(b)). Regulation W exempts 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.[65] In addition, the statute provides that covered transactions between sister banks must be consistent with safe and sound banking practices.[66]

The sister-bank exemption, by its terms, only exempts transactions by a member bank with a sister-bank affiliate;[67] hence, the sister-bank exemption cannot exempt a member bank's extension of credit or other covered transaction to an affiliate that is not a sister bank (even if the extension of credit was purchased from a sister bank). For example, 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 section 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 section 223.3(h)(1) that does not qualify for the sister-bank exemption.

Internal corporate reorganizations. Section 223.41(d) of Regulation W provides an exemption for asset purchases by a bank from an affiliate that are part of a one-time internal corporate reorganization of a banking organization.[68] The exemption includes purchases of assets in connection with a transfer of securities issued by an affiliate to a member bank, as described in section 223.31(a).

Under this exemption, a member bank would be permitted to purchase assets (other than low-quality assets) from an affiliate (including in connection with an affiliate share transfer that section 223.31 of the rule treats as a purchase of assets) exempt from the quantitative limits of section 23A if the following conditions are met.

First, the 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 to an IDI.[69] The asset purchase must not be part of a series of periodic, ordinary-course asset transfers from an affiliate to a member bank.[70] Second, the member 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.[71] Third, a majority of the member bank's directors must review and approve the transaction before consummation. Fourth, the section 23A value of the covered transaction must be less than 10 percent of the member 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 appropriate federal banking agency). Fifth, the 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.

65. Banks that are affiliated in this manner are referred to as "sister banks." Sister banks can improve their efficiency through intercorporate transfers under this exception. Also, "company" in this context is not limited to a BHC. For example, if a retail corporation owns two credit card banks, the two credit card banks would be sister banks, although owned by a retail corporation, and the sister-bank exemption could be used for transactions between two credit card banks.

66. A member bank and its operating subsidiaries are considered a single unit for purposes of section 23A. Under the statute and the regulation, transactions between a member bank (or its operating subsidiary) and the operating subsidiary of a sister IDI generally qualify for the sister-bank exemption.

67. The sister-bank exemption in section 23A does not allow a member bank to avoid any restrictions on sister-bank transactions that may apply to the bank under the prompt-corrective-action framework set forth in section 38 of the FDI Act (12 USC 1831o) and regulations adopted thereunder by the bank's appropriate federal banking agency.

68. See 1998 *Fed. Res. Bull.* 985 and 1013–14.

69. The notice also must describe the primary business activities of the affiliate whose shares or assets are being transferred to the member bank and must indicate the anticipated date of the reorganization.

70. The IDI must provide the Board, as well as the appropriate federal agency, a notice that describes the primary business activities of the affiliate whose shares or assets are being transferred to the IDI and must indicate the anticipated date of the reorganization.

71. The holding company can meet these criteria either by repurchasing the assets at book value plus any write-down that has been taken or by making a quarterly cash contribution to the bank equal to the book value plus any write-downs that have been taken by the bank. The purchase or payment must be made within 30 days of each quarter end. In addition, if a cash payment is made, the member bank will hold an amount of risk-based capital equal to the book value of any transferred asset that becomes low-quality so long as the bank retains ownership of the transferred asset. For example, under this dollar-for-dollar capital requirement, the risk-based capital charge for each transferred low-quality loan asset would be 100 percent (equivalent to a 1250 percent risk weight) rather than the 8 percent requirement (equivalent to a 100 percent risk weight) that would apply to a similar defaulted loan asset that is not a part of the transferred asset pool. See Board letter dated December 21, 2007, to Andres L. Navarette (Capital One Financial Corp.)

Covered Transactions Also Exempt from the Quantitative Limits, Collateral Requirements, and Low-Quality-Asset Prohibition

The quantitative limits (sections 223.11 and 223.12), the collateral requirements (section 223.14), and the prohibition on the purchase of a low-quality asset (section 223.15) do not apply to the following exempted transactions. (See section 223.42.) The transactions are, however, subject to the safety-and-soundness requirement (section 223.13) and certain conditions. Detailed conditions or restrictions pertaining to these exemptions are discussed after this list.

1. Making correspondent banking deposits in an affiliated depository institution (as defined in section 3 of the FDI Act (12 USC 1813)) or an affiliated foreign bank that represent an ongoing, working balance maintained in the ordinary course of correspondent business
2. Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business
3. Transactions secured by cash or U.S. government securities
4. Purchasing securities of a servicing affiliate as defined by the BHC Act
5. Purchasing certain liquid assets
6. Purchasing certain marketable securities
7. Purchasing certain municipal securities
8. Purchasing from an affiliate an extension of credit subject to a repurchase agreement that was originated by a member bank and sold to the affiliate subject to a repurchase agreement or with recourse
9. Asset purchases 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 the review of the formation of the member bank
10. Transactions approved under the Bank Merger Act that involve affiliated federally IDIs and the U.S. branches and agencies of a foreign bank
11. Purchasing, on a nonrecourse basis, an extension of credit from an affiliate
12. Intraday extensions of credit
13. Riskless-principal transactions

Correspondent banking. Section 23A exempts from its quantitative limits and collateral requirements a deposit by a member bank in an affiliated bank or affiliated foreign bank that is made in the ordinary course of correspondent business, subject to any restrictions that the Board may impose.[72] Section 223.42(a) of the rule further provides that such deposits must represent ongoing, working balances maintained by the member bank in the ordinary course of conducting the correspondent business.[73] Although not required by section 23A or the Home Owners' Loan Act (HOLA), the rule also provides that correspondent deposits in an affiliated insured savings association are exempt if they otherwise meet the requirements of the exemption.

Secured credit transactions. Section 23A and section 223.42(c) of the rule exempt any credit transaction by a member bank with an affiliate that is "fully secured" by obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest.[74] A deposit account meets the "segregated, earmarked" requirement only if the account exists for the sole purpose of securing credit transactions between the member bank and its affiliates and is so identified. Under section 23A, if U.S. government obligations or deposit accounts are sufficient to fully secure a credit transaction, then the transaction is completely exempt from the quantitative limits of the statute. If, however, the U.S. government obligations or deposit accounts represent less than full security for the credit transaction, then the amount of U.S. government obligations or deposits counts toward the collateral requirements of section 23A, but no part of the transaction is exempt from the statute's quantitative limits.

The exemption provides that a credit transaction with an affiliate will be exempt "to the extent that the transaction is and remains secured" by appropriate (d)(4) collateral. If a member bank makes a $100 nonamortizing term loan to an affiliate that is secured by $50 of U.S. Treasury securities and $75 of real estate, the value of the covered transaction will be $50. If the market value of the U.S. Treasury securities falls to $45 during the life of the loan, the value

72. 12 USC 371c(d)(2).

73. Unlike the sister-bank exemption, the exemption for correspondent banking deposits applies to deposits placed by a member bank in an uninsured depository institution or foreign bank.

74. 12 USC 371c(d)(4). A partial list of such obligations can be found at 12 CFR 201.108.

of the covered transaction would increase to $55. The Board expects member banks that use this expanded (d)(4) exemption to review the market value of their U.S. government obligations collateral regularly to ensure compliance with the exemption.

Purchases of assets with readily identifiable market quotes. Section 23A(d)(6) exempts the purchase of assets by a member bank from an affiliate if the assets have a "readily identifiable and publicly available market quotation" and are purchased at their current market quotation. The rule (section 223.42(e)) limits the availability of this exemption (the (d)(6) exemption) to purchases of assets with market prices that are recorded in widely disseminated publications that are readily available to the general public, such as newspapers with a national circulation. Because as a general matter only exchange-traded assets are recorded in such publications, this test has ensured that the qualifying assets are traded actively enough to have a true "market quotation" and that examiners can verify that the assets are purchased at their current market quotation. The rule applies if the asset is purchased at or below the asset's current market quotation.[75]

If a member bank purchases from one affiliate securities issued by another affiliate, the bank has engaged in two types of covered transactions: a purchase of securities from an affiliate and the investment in securities issued by an affiliate. Under the rule, although the (d)(6) exemption may exempt the one-time asset purchase from the first affiliate, it would not exempt the ongoing investment in securities being issued by the second affiliate.

The (d)(6) exemption may apply to a purchase of assets that are not traded on an exchange. In particular, purchases of foreign exchange, gold, and silver, and purchases of over-the-counter (OTC) securities and derivative contracts, whose prices are recorded in widely disseminated publications, may qualify for the (d)(6) exemption.

75. The rule provides that a U.S. government obligation is an eligible (d)(6) asset only if the obligation's price is quoted routinely in a widely disseminated publication that is readily available to the general public. Although all U.S. government obligations have low credit risk, not all U.S. government obligations trade in liquid markets at publicly available market quotations.

Purchases of Certain Marketable Securities under Regulation W. Regulation W provided an additional exemption from section 23A for certain purchases of securities by a member bank from an affiliate. The rule expanded the statutory (d)(6) exemption to allow a member bank to purchase securities from an affiliate based on price quotes obtained from certain electronic services so long as, among other things, the selling affiliate is a broker–dealer registered with the SEC, the securities have a ready market and are eligible for purchase by state member banks, the securities are not purchased within 30 days of an underwriting (if an affiliate of the bank is an underwriter of the securities), and the securities are not issued by an affiliate. All securities purchases are subject to section 23B.

- *Broker–Dealer Requirement.* Under Regulation W, the selling affiliate must be a broker–dealer securities affiliate that is registered with the SEC. Broker–dealers that are registered with the SEC are subject to supervision and examination by the SEC and are required by SEC regulations to keep and maintain detailed records concerning each securities transaction conducted by the broker–dealer. In addition, SEC-registered broker–dealers have experience in determining whether a security has a "ready market" under SEC regulations. The rule does not expand the exemption to include securities purchases from foreign broker–dealers. The rule explicitly provides, however, that a member bank may request that the Board exempt securities purchases from a particular foreign broker–dealer, and the Board would consider these requests on a case-by-case basis in light of all the facts and circumstances.
- *Securities eligible for purchase by a state member bank.* The exemption requires that the bank's purchase of securities be eligible for purchase by a state member bank. For example, the Board determined that a member bank may purchase equity securities from an affiliate if the member bank's purchase is made to hedge the bank's permissible customer-driven equity derivative transaction. The purchase must be treated as a purchase of a security on the bank Call Report.
- *No purchases within 30 days of an underwriting.* The exemption generally prohibits a member bank from using the exemption to purchase securities during an underwriting, or within 30 days of an underwriting, if an

affiliate of the bank is an underwriter of the securities. This provision applies 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. The rule includes the 30-day requirement because of the uncertain and volatile market values of securities during and shortly after an underwriting period and because of the conflicts of interest that may arise during and after an underwriting period, especially if an affiliate has difficulty selling its allotment.

- *No securities issued by an affiliate.* If a member bank purchases from one affiliate securities issued by another affiliate, it would not exempt the investment in securities issued by the second affiliate, even though the (d)(6) exemption may exempt the asset purchase from the first affiliate. The transaction would be treated as a purchase of, or an investment in, securities issued by an affiliate.
- *Price-verification methods.* The (d)(6) exemption applies only in situations in which the member bank is able to obtain price quotes on the purchased securities from an unaffiliated electronic, real-time pricing service. The Board reaffirms its position that it would not be appropriate to use independent dealer quotations or economic models to establish a market price for a security under the (d)(6) exemption. A security that is not quoted routinely in a widely disseminated news source or a third-party electronic financial network may not trade in a sufficiently liquid market to justify allowing a member bank to purchase unlimited amounts of the security from an affiliate.
- *Record retention.* The rule expressly includes a two-year record-retention and supporting information requirement that is sufficient to enable the appropriate federal banking agencies to ensure that the member bank is in compliance with the terms of the (d)(6) exemption.

Purchasing municipal securities. Section 223.42(g) of the rule exempts a member bank's purchase of municipal securities from an affiliate if the purchase meets certain requirements.[76] First, the member bank must purchase the municipal securities from a broker–dealer affiliate that is registered with the SEC. Second, the municipal securities must be eligible for purchase by a state member bank, and the member bank must report the transaction as a securities purchase in its Call Report. Third, the municipal securities must either be rated by a nationally recognized statistical rating organization (NRSRO) or must be part of an issue of securities that does not exceed $25 million in size. Finally, the price for the securities purchased must be (1) quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks; (2) verified by reference to two or more actual independent dealer quotes on the securities to be purchased or securities that are comparable to the securities to be purchased; or (3) in the case of securities purchased during the underwriting period, verified by reference to the price indicated in the syndicate manager's written summary of the underwriting.[77] Under any of the three pricing options, the member bank must purchase the municipal securities at or below the quoted or verified price, and all purchases are subject to section 23B.

Purchases of assets by newly formed banks. Section 223.42(i) of the rule exempts a purchase of assets by a newly formed member bank from an affiliate if the appropriate federal banking agency for the bank has approved the purchase. This exemption allows companies to charter a new bank and to transfer assets to the bank free of the quantitative limits and low-quality-asset prohibition of section 23A.

Transactions approved under the Bank Merger Act. The Bank Merger Act exemption applies to transactions between a member bank and certain IDI affiliates. Section 223.42(j) exempts transactions between IDIs that are approved pursuant to the Bank Merger Act. The rule also makes the Bank Merger Act exemption available for mergers and other related transactions between a member bank and a U.S. branch or agency of an

76. Municipal securities are defined by reference to section 3(a)(29) of the Securities Exchange Act. That act defines municipal securities as direct obligations of, or obligations guaranteed as to principal or interest by, a state or agency, instrumentality, or political subdivision thereof, and certain tax-exempt industrial development bonds. (See 17 USC 78c(a)(29).)

77. Under the Municipal Securities Rulemaking Board's Rule G-11, the syndicate manager for a municipal bond underwriting is required to send a written summary to all members of the syndicate. The summary discloses the aggregate par values and prices of bonds sold from the syndicate account.

affiliated foreign bank, if the transaction has been approved by the responsible federal banking agency pursuant to the Bank Merger Act, and should help ensure that such transactions do not pose significant risks to the member bank. There is no regulatory exemption for merger transactions between a national bank and its nonbank affiliate. Any member bank merging or consolidating with a nonbank affiliate may be able to take advantage of the regulatory exemption for internal-reorganization transactions contained in section 223.41(d) of the rule.

Purchases of extensions of credit—the purchase exemption. Regulation W codified, with changes, the exemption that previously was found at 12 CFR 250.250. In general,

- The purchase of an extension of credit on a nonrecourse basis from an affiliate is exempt from section 23A's quantitative limits provided that—
  - the extension of credit is originated by the affiliate,
  - 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,
  - the member bank commits to purchase the extension of credit before the affiliate makes or commits to the extension of credit, and
  - the member bank does not make a blanket advance commitment to purchase extensions of credit from the affiliate. (See section 223.42(k) of the rule.)

  The rule also includes a 50 percent limit on the amount of loans a bank may purchase from an affiliate under the purchase exemption. When a member 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 member 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.
- *"Substantial, ongoing funding" test.* The rule allows the appropriate federal banking agency for a member bank to reduce the 50 percent threshold prospectively, on a case-by-case basis, in those situations in which the agency believes that the bank's asset purchases from an affiliate under the exemption may cause harm to the bank.
- *Independent credit review by the bank.* To qualify for the purchase exemption under section 223.42(k), a member bank must independently review the creditworthiness of the borrower before committing to purchase each loan. Under established Federal Reserve guidance, a bank is required to have clearly defined policies and procedures to ensure that it performs its own due diligence in analyzing the credit and other risks inherent in a proposed transaction.[78] This function is not delegable to any third party, including affiliates of the member bank. Accordingly, to qualify for this exemption, the member bank, independently and using its own credit policies and procedures, must itself review and approve each extension of credit before giving a purchase commitment to its affiliate.
- *Purchase of loans from an affiliate must be without recourse.* In connection with a bank's purchase of loans from an affiliate, the affiliate cannot retain recourse on the loans. The rule (section 223.42(k)) specifies that the exemption does not apply in situations where the affiliate retains recourse on the loans purchased by the member bank. The rule also specifies that the purchase exemption only applies in situations where the member bank purchases loans from an affiliate that were originated by the affiliate. The exemption cannot be used by a member bank to purchase loans from an affiliate that the affiliate purchased from another lender. The exemption is designed to facilitate a member bank's using its affiliate as an origination agent, not to permit a member bank to take off an affiliate's books loans that the affiliate purchased from a third party.

Intraday extensions of credit. Section 223.42(l) of the rule provides that intraday credit extensions by a member bank to an affiliate are extensions of credit under section 23A covered transactions but exempts all such intraday credit extensions from the quantitative and collateral requirements of section 23A if the member bank

78. See, for example, SR-97-21.

(1) maintains policies and procedures for the management of intraday credit exposure and (2) has no reason to believe that any affiliate receiving intraday credit would have difficulty repaying the credit in accordance with its terms. The establishment of policies and procedures are for—

- 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
- ensuring that any intraday extensions of credit by the member bank to an affiliate comply with the market-terms requirement of section 223.51 of the rule.

Standard under which the Board may grant additional exemptions. The FDIC, OCC, and the Board may grant additional section 23A exemptions requested on a case-by-case basis for the institutions they supervise. The FDIC must find that the exemptions do not present unacceptable risk to the insurance fund. In addition, the Board and the FDIC must find that the exemptions are in the public interest.

Exemptions and Interpretation from the Attribution Rule of Section 23A

The attribution rule of section 23A provides that "a transaction by a member bank with any person shall be deemed a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate" (12 USC 371c(a)(2)). One respective interpretation and three exemptions are discussed below.

Interpretation—Loans to a nonaffiliate that purchases securities or other assets through a depository institution affiliate agent or broker. In Regulation W, the Board issued an interpretation (12 CFR 223.16(b)) regarding a member bank's loan to a nonaffiliate that purchases assets through an institution's affiliate that is acting as agent. This interpretation confirms that section 23A of the FRA does not apply to extensions of credit an IDI grants to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as (1) the affiliate is acting exclusively as an agent or broker in the transaction and (2) the affiliate retains no portion of the loan proceeds as a fee or commission for its services.

Under this interpretation, the Board concluded that when the affiliated agent or broker retains a portion of the loan proceeds as a fee or commission, the portion of the loan not retained by the affiliate as a fee or commission would still be outside the coverage of section 23A. On the other hand, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board, however, granted an exemption from section 23A for that portion of a loan to a third party that an affiliate retains as a market-rate brokerage or agency fee. (See 12 CFR 223.16(c)(2).)

The interpretation would not apply if the securities or other assets purchased by the third-party borrower through the affiliate of the depository institution were issued or underwritten by, or sold from the inventory of, another affiliate of the depository institution. In that case, the proceeds of the loan from the depository institution would be transferred to, and used for the benefit of, the affiliate that issued, underwrote, or sold the assets on a principal basis to the third party.

The above-mentioned transactions are subject to the market-terms requirement of section 23B, which applies to "any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person" (12 USC 371c-1(a)(2)(D)). A market-rate brokerage commission or agency fee refers to a fee or commission that is no greater than that prevailing at the same time for comparable agency transactions the affiliate enters into with persons who are neither affiliates nor borrowers from an affiliated depository institution. (See Regulation W at 12 CFR 223.16(b).)

Exemption—Loans to a nonaffiliate that purchases securities from a depository institution securities affiliate that acts as a riskless principal. The Board has granted an exemption in Regulation W from section 23A of the FRA for extensions of credit by an IDI to customers who use the loan proceeds to purchase a security that is issued by a third party via a broker–dealer affiliate of the institution that acts as riskless principal. The exemption for riskless-principal transactions would not apply if the broker-

–dealer affiliate sold to the third-party borrower securities that were issued or underwritten by, or sold out of the inventory of, an affiliate of the depository institution. Riskless-principal trades, although the functional equivalent of securities brokerage transactions, involve the purchase of a security by the depository institution's broker–dealer affiliate. Accordingly, the broker–dealer retains the loan proceeds at least for some moment in time.

There is negligible risk that loans a depository institution makes to borrowers to engage in riskless-principal trades through a broker–dealer affiliate of the depository institution would be used to fund the broker–dealer. For this reason, the Board adopted an exemption from section 23A to cover riskless-principal securities transactions engaged in by depository institution borrowers through broker–dealer affiliates of the depository institution. This exemption is applicable even if the broker–dealer retains a portion of the loan proceeds as a market-rate markup for executing the riskless-principal securities trade. (See Regulation W at 12 CFR 223.16(c)(1) and (2).

Exemption—Depository institution loan to a nonaffiliate pursuant to a preexisting line of credit and the proceeds are used to purchase securities from the institution's broker–dealer affiliate. The Board approved an exemption in Regulation W from section 23A for loans by an IDI to a nonaffiliate pursuant to a preexisting line of credit, in which the loan proceeds are used to purchase securities from a broker–dealer affiliate. In more detail, the Board exempted extensions of credit by an IDI to its customers that use the credit to purchase securities from a registered broker–dealer affiliate of the institution, so long as the extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit. This line of credit should not have been established in expectation of a securities purchase from or through an affiliate of the institution. The preexisting requirement is an important safeguard to ensure that the depository institution did not extend credit for the purpose of inducing a borrower to purchase securities from or issued by an affiliate. The preexisting line of credit exemption may not be used in circumstances in which the line has merely been preapproved. (See Regulation W at 12 CFR 223.16(c)(3)).

Exemption—Credit card transactions. Regulation W also provides an exemption from section 23A's attribution rule for general-purpose credit card transactions that meet certain criteria. (See section 223.16(c)(4).) The rule defines a general-purpose credit card as a credit card issued by a member 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. 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 member bank) are subject to the rule.

The credit card exemption includes several different methods that are provided for a member bank to demonstrate that its credit card meets the 25 percent test. If a member bank has no commercial affiliates (other than those permitted for a financial holding company (FHC) under 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. (A member bank could use this method of complying with the 25 percent test even if, for example, the bank's FHC controls, under section 4(a)(2), 4(c)(2), or 4(k)(4)(H) of the BHC Act, several companies engaged in nonfinancial activities.) Such a member bank would not be obligated to establish systems to verify strict, ongoing compliance with the 25 percent test. If a member bank has commercial affiliates (beyond those permitted for an FHC under section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if—

- the bank establishes systems to verify 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 would comply with the 25 percent test. (One way that a member bank could demonstrate that its card would comply with the 25 percent test would be to show that the total sales of the bank's affiliates are less than 25 percent of the total purchases by cardholders.)

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

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 section 223.16, paragraph (c)(4)(ii)(A), of the rule. The member bank assesses its compliance under paragraph (c)(4)(iii) of this section on the 15th day of every month (for the preceding 12 calendar months). The credit card qualifies as a general-purpose credit card for at least three consecutive months. On June 15, 2005, however, the member bank determines that, for the 12-calendar-month 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. Unless the credit card returns to compliance with the 25 percent limit by the 12-calendar-month period ending August 31, 2005, the card will cease to qualify as a general-purpose credit card as of September 1, 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.

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

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. By its terms, sections 23A and 23B of the FRA do not apply to the U.S. branches, agencies, or commercial lending offices of foreign banks. The Board, however, used its authority that it was granted by the GLB Act to impose restrictions on transaction between the branches, agencies, and lending offices and any affiliate of the foreign bank that operates in the United States in order to ensure that such transactions met certain prudential standards and provided competitive equality with U.S. banking organizations. The Board accomplished these goals by imposing the definition of affiliate of sections 23A and 23B on transactions between the branches, agencies, and lending offices and those affiliates if the company is also

1. directly engaged in the United States in certain activities. These activities are significant because a U.S. bank cannot engage in these activities directly or through an operating subsidiary, and the 23A and 23B limitations help ensure competitive equality between U.S. banks and foreign banks. These activities are as follows:
   - Insurance underwriting pursuant to section 4(k)(4)(B) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(B));
   - Securities underwriting, dealing, or market making pursuant to section 4(k)(4)(E) of the Bank Holding Company Act (12 USC 1843(k)(4)(E));
   - Merchant banking activities pursuant to section 4(k)(4)(H) of the Bank Holding Company Act (12 USC 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);
   - Insurance company investment activities pursuant to section 4(k)(4)(I) of the Bank Holding Company Act (12 USC 1843(k)(4)(I)); or
   - 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 section 223.2 if such branch, agency, or commercial lending company were a member bank; or
3. a subsidiary of an affiliate as described in paragraph (b)(1) or (2) of section 223.61.

Regulation W also provides that for purposes of subpart G, the "capital stock and surplus" 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.

SECTION 23B OF THE FEDERAL RESERVE ACT

Section 23B of the FRA became law on August 10, 1987, as part of the Competitive Equality Banking Act of 1987. This section also regulates transactions with affiliates. Section 23B applies to any covered transactions with an affiliate but excludes banks from the term "affiliate" as that term is defined in section 23A.

Regulation W, subpart F, sets forth the principal restrictions of section 23B. These include (1) a requirement that most transactions between a member bank and its affiliates be on terms and circumstances that are substantially the same as those prevailing at the time for comparable transactions with nonaffiliates; (2) a restriction on a member bank's purchase as fiduciary of assets from an affiliate unless certain criteria are met; (3) a restriction on a member bank's purchase, during the existence of an underwriting syndicate, of any security if a principal underwriter of the security is an affiliate; and (4) a prohibition on publishing an advertisement or entering into an agreement stating that a member bank will be responsible for the obligations of its affiliates. For the most part, subpart F restates the operative provisions of section 23B. The following transactions with affiliates are covered by section 23B:

- any covered transaction with an affiliate
- the sale of securities or other assets to an affiliate, including assets subject to repurchase
- the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise
- any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person
- any transaction or series of transactions with a nonaffiliate if an affiliate—
  - — has a financial interest in the third party or
  - — is a participant in the transaction or series of transactions

Any transaction by a member bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. A member bank and its subsidiaries may engage in the transactions covered by section 23B of the FRA only on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with, or that in good faith would be offered to, nonaffiliate companies.

Section 23B restricts the following transactions with affiliates:

- A member bank or its subsidiary cannot purchase as fiduciary any securities or other assets from any affiliate unless the purchase is permitted—
  - — under the terms of the instrument creating the fiduciary relationship,
  - — by court order, or
  - — by the law of the jurisdiction governing the fiduciary relationship.
- A member bank or its subsidiary, whether acting as principal or fiduciary, cannot knowingly purchase or acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of the bank. This limitation applies unless the purchase or acquisition of the security has been approved before it is initially offered for sale to the public by a majority of the directors of the bank. The purchase should be based on a determination that it is a sound investment for the bank irrespective of the fact that an affiliate of the bank is a principal underwriter of the securities.

Transactions Exempt from Section 23B of the Federal Reserve Act

The market-terms requirement of section 23B applies to, among other transactions, any "covered transaction" between a member bank and an affiliate.[79] Section 23B(d)(3) makes clear that the term "covered transaction" in section 23B has the same meaning as the term "covered transaction" in section 23A but does not include any transaction that is exempt under section 23A(d)—for example, transactions between sister banks,[80] transactions fully secured by a deposit account or U.S. government obligations, and purchases of assets from an affiliate at a

79. 12 USC 371c-1(a)(2)(A).

80. Although transactions between banks are exempt from section 23B, the safety-and-soundness provisions of section 23A apply and generally require that transactions be conducted on terms similar to those terms and standards outlined in section 23B.

readily identifiable and publicly available market quotation.[81] Consistent with the statute, Regulation W's section 223.52(a)(1) exempts from section 23B any transaction that is exempt under section 23A(d).[82]

The rule also excludes from section 23B any covered transaction that is exempt from section 23A under section 223.42(i) or (j) (that is, asset purchases by a newly formed member bank and transactions approved under the Bank Merger Act). The Board excluded from section 23B this additional set of transactions because, in each case, the appropriate federal banking agency for the member bank involved in the transaction should ensure that the terms of the transaction are not unfavorable to the bank.

Other transactions that are exempt from section 23A are subject to section 23B, however. The purchase of marketable securities, municipal securities, and extensions of credit are subject to the market terms requirement of section 23B. In addition, intraday extensions of credit and riskless principal transactions between an IDI and an affiliate are subject to the market terms requirement of the statute and regulation. (See 12 CFR 223.52(a)(1) and 223.42(f), (g), (k), (1), and (m).)

Purchases of Securities for Which an Affiliate Is the Principal Underwriter

The GLB Act amended section 23B to permit a member bank to purchase securities during an underwriting conducted by an affiliate if the following two conditions are met. First, a majority of the directors of the member bank (with no distinction drawn between inside and outside directors) must approve the securities purchase before the securities are initially offered to the public. Second, such approval must be based on a determination that the purchase would be a sound investment for the member bank regardless of the fact that an affiliate of the bank is a principal underwriter of the securities.[83] Section 223.53(b) includes this standard and clarifies that if a member bank proposes to make such a securities purchase in a fiduciary capacity, then the directors of the bank must base their approval on a determination that the purchase is a sound investment for the person on whose behalf the bank is acting as fiduciary.

A member bank may satisfy this director-approval requirement by obtaining specific prior director approval of each securities acquisition otherwise prohibited by section 23B(b)(1)(B). The rule clarifies, however, that a member bank also satisfies this director-approval requirement if a majority of the directors of the bank approves appropriate standards for the bank's acquisition of securities otherwise prohibited by section 23B(b)(1)(B), and each such acquisition meets the standards adopted by the directors. In addition, a majority of the member bank's directors must periodically review such acquisitions to ensure that they meet the standards and must periodically review the standards to ensure they meet the "sound investment" criterion of section 23B(b)(2). The appropriate period of time between reviews would vary depending on the scope and nature of the member bank's program, but such reviews should be conducted by the directors at least annually. Before the passage of the GLB Act, Board staff informally allowed member banks, based on the legislative history of section 23B, to meet the director-approval requirement in this fashion, and there is no indication that Congress in the GLB Act intended to alter the procedures that a member bank could use to obtain the requisite director approval.[84] The rule codifies staff's preexisting approach to the director-approval requirement.[85]

81. 12 USC 371c-1(d)(3).

82. Regulation W will again be subsequently referred to as the "rule" or by its specified section-numbered discussion of section 23B provisions.

83. 12 USC 371c-1(b)(2). The rule provides that a U.S. government obligation is an eligible (d)(6) asset only if the obligation's price is quoted routinely in a widely disseminated publication that is readily available to the general public. Although all U.S. government obligations have low credit risk, not all U.S. government obligations trade in liquid markets at publicly available market quotations.

84. The conference report accompanying the Competitive Equality Banking Act of 1987 stated that the prior-approval requirement of section 23B(b) could be met "by the establishment in advance of specific standards by the outside directors for such acquisitions. If the outside directors establish such standards, they must regularly review acquisitions to assure that the standards have been followed, and they must periodically review the standards to assure that they continue to be appropriate in light of market and other conditions." See H.R. Conf. Rep. No. 100-261 at 133 (1987).

85. The rule also provides, consistent with existing Board interpretations, that a U.S. branch, agency, or commercial lending company of a foreign bank may comply with this requirement by obtaining the required approvals and reviews from either a majority of the directors or a majority of the senior executive officers of the foreign bank.

Definition of Affiliate Under Section 23B

Section 23B states that the term "affiliate" under section 23B has the meaning given to such term in section 23A except that the term "affiliate" under section 23B does not include a "bank," as defined in section 23A.[86] In the case of the sister-bank exemption, the rule's section 223.2(c) clarifies that the only companies that qualify for the "bank" exception to section 23B's definition of affiliate are insured depository institutions.

86. 12 USC 371c-1(d)(1).

Advertising and Guarantee Restriction

In section 23B(c), the "advertising restriction" prohibits a member bank from publishing any advertisement or entering into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates. Regulation W clarifies this restriction to permit such guarantees and similar transactions if the transaction satisfies the quantitative and collateral restrictions of section 23A.[87] The rule also clarifies that section 23B(c) does not prohibit a member bank from making reference to such a guarantee, acceptance, or letter of credit in a prospectus or other disclosure document, for example, if otherwise required by law.

87. 12 USC 371c-1(c).

Regulation W: Transactions Between Member Banks and Their Affiliates

Examination Objectives

Effective date May 2001

Section 6070.2

1. To determine compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.
2. To determine the relationships between the bank and its affiliates and the effects of those relationships and their transactions on the operations and safety and soundness of the bank.
3. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

1. *Section 23A of the Federal Reserve Act (12 USC 371c), Relations with Affiliates, and the Board's Regulation W.* By coordinating work with the examiners assigned to the various loan areas, determine compliance with laws and regulations pertaining to related organizations by performing the following procedures.
   a. Obtain a listing of loans to affiliates.
   b. Compare the listing with the bank's customer liability records to determine the list's accuracy and completeness.
   c. Obtain a listing of other covered transactions with affiliates (that is, for example, purchase of securities issued by an affiliate, purchase of assets, acceptance of securities issued by an affiliate as collateral for a loan to any person or company, or the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate).
   d. Conduct transaction testing of intercompany affiliate transactions[1] for compliance with the limitations of section 23A of the Federal Reserve Act and the Board's Regulation W (see SR-03-02) by—
      - reviewing—
        — the time elapsed between the original issuance of the affiliate's debt securities and the bank's purchase,
        — the existence of any relevant agreements or relationships between the bank and the third-party seller of the affiliate's debt securities,
        — any history of bank financing of the affiliate, and
        — any other relevant information;
      - documenting any violations or potential violations, and reaching an agreement with the directors and senior management to resolve violations quickly; and
      - considering the inclusion of defaulted country risk problem assets in the evaluation of asset quality and capital adequacy. (See section 7040.1.)
   e. Ensure that transactions with affiliates meet the collateral requirements of section 23A.
   f. Ensure that low-quality loans have not been purchased from an affiliate.
   g. Determine that all transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
   h. *Policies and procedures.*
      - Obtain the bank's policies and procedures to determine compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.
      - Ensure the policies and procedures cover all relevant affiliates (e.g., financial subsidiaries and joint ventures) and transactions covered by section 23A, and verify that the bank treats "sponsored and advised" companies as affiliates ("Sponsored and advised" companies would include, at a minimum, any company that receives investment advice and administrative services on a contractual basis from a member bank, whose trustees or managers are selected by the bank, and that has a name similar to that of the bank.).
      - Ensure that the policies and procedures are comprehensive and include adequate controls—
        — to identify covered transactions and
        — to ensure that necessary steps are performed for identified transactions (e.g., the required collateralization of loans to affiliates).
   i. *Covered transactions.*
      - If the controls for section 23A are considered adequate, use the list of covered transactions provided by the bank.
      - If controls are considered inadequate (for example, for transactions testing), review the bank's general ledger to identify transactions that are covered transactions.
      - Verify that covered transactions count against required limits and are collateralized when required.

1. Examples of affiliates include a bank holding company and its nonbank subsidiaries, companies under the member bank's control (see Regulation W, section 223.3(g)), any mutual fund advised by a member bank, merchant banking investments, a member bank or affiliate serving as a general partner in a partnership, and affiliates' subsidiaries. In addition, certain joint venture companies, ESOPs of banks and their affiliates, and special-purpose entities are affiliates if the regulatory definitions of control are met.

- If the bank uses an internal rating system for its assets, determine that the bank has not deferred or altered an asset's rating to facilitate sale of the asset to an affiliate.
- Review controls for monitoring compliance with the established limits and for collateralizing required credit-extension transactions.
- If controls are considered inadequate (for example, for transactions testing), ensure that covered transactions are properly valued.
- Verify that identified covered transactions comply with the limits of sections 23A and 23B (If the covered transactions do not comply with the limits, criticize the bank for inadequate controls, and discuss what steps the bank will use to correct the violations).
- Obtain collateral listings, and verify that necessary covered transactions are adequately collateralized:
  - — Verify that the values of omnibus deposit accounts used to secure covered transactions are sufficient to fully secure the relevant covered transactions.
  - — Review collateral documentation to ensure that the bank's interest is adequately perfected and prioritized (Regulation W, section 223.14(d)).

j. *Corporate lending (funding).* Ensure that there is compliance with the collateral requirements and quantitative limits:

- Obtain the bank's ″trial balances″ of loans.
- Check that loans to affiliates are included on the list of "covered transactions" and included in measurements for compliance with the quantitative limits. If some loans are not included, ascertain why.
- If an exemption is being used, verify that its application is correct.
- Verify that the loans are collateralized (using collateral listings), and review the documentation to ensure proper collateralization.

k. *Verification of exemptions.*

- For renewal of participations involving problem loans (see Regulation W, section 223.15(b)) involving nondepository affiliates, review supporting documentation to ensure that—
  - — the loan was not low quality at the time the bank purchased the participation,
  - — the renewal is approved at the board committee or senior management level as appropriate, and
  - — the bank's share of the renewal does not exceed its original share by more than 5 percent (unless approved by an appropriate federal bank regulator) and that the bank notified the federal bank regulator within 20 days.
- For retail lending (e.g., credit cards and mortgage banking) involving the funding of loans and the purchase of loans, ensure compliance with quantitative limits (for funding and compliance with collateral requirements) as follows:
  - — For credit card examinations, obtain the "trial balances" of the outstanding balances, and for mortgage banking, obtain lists of the loans sold.
  - — Check that credit card amounts generated by bank affiliates and mortgage loans sold to the bank by affiliates are included on the list of covered transactions and in measurements for compliance with the quantitative limits. If they are not included, ascertain why.
  - — If an exemption is being used, verify that its use is correct.
  - — Verify that loans are collateralized (using collateral), and review the documentation to ensure proper collateralization.
- For the general-purpose credit card exemption (Regulation W, section 223.16(c)(4)), verify, through review of relevant documentation, that the bank can demonstrate that its credit card meets the less than 25 percent test through one of three available methods. (An exemption from the attribution rule for extensions of credit under a general-purpose credit card is defined as one on which "less than 25 percent of the aggregate amount of purchases are purchases from a bank affiliate.")
  - — The bank has no commercial affiliates.
  - — The bank establishes systems to verify compliance with the less than 25 percent test on an ongoing basis.

  - — The bank presents information to the Board of Governors to demonstrate its card would comply.
- For purchases of extensions of credit—the “250.250 exemption” (Regulation W, section 223.42(k))—review supporting documentation to ensure that—
  - — the member bank makes an independent creditworthiness evaluation before the affiliate makes or commits to make the loan,
  - — the bank commits to make the loan purchase before the affiliate makes the loan,
  - — the bank does not make a blanket advance commitment to purchase loans, and
  - — the purchases from the affiliate by the depository institution and all depository institution affiliates in the prior 12 months represent 50 percent or less of all loans originated by the affiliate during such period.

l. If the bank is critically undercapitalized (under prompt-corrective-action rules), determine if the bank has engaged in any covered transaction, as defined in section 23A, without the prior approval of the FDIC or FRS.

m. *Internal controls.*
- Determine the bank’s methods for identifying transactions subject to sections 23A and 23B of the Federal Reserve Act. Determine if these methods adequately identify such transactions. Consider the following information:
  - — internal reports (Management should document any covered transactions with affiliates.)
  - — loan records
  - — deposit accounts
  - — accounts payable and receivable
  - — board minutes
- Determine if management understands what services its affiliates provide.
- Determine the volume and frequency of inter-institution transactions, such as loan participations or sales, purchases or sales of other assets, bank stock loans, insider transactions, and contractual obligations for services. Review these transactions for possible noncompliance or abusive practices.
- Review any formal or informal agreements regarding covered transactions. Determine if management adequately documents the cost, fee structure, and quality of services.
- Determine the bank’s compliance with any outstanding conditions of an approved order or commitment issued by the regulator.

n. Determine if the affiliates are in compliance with the capital requirements of their functional regulator.

o. If the bank has used the expanded (d)(4) exemption, determine that the bank regularly reviews the market value of its U.S. government obligations collateral.

p. Determine that the bank’s program for monitoring and controlling the credit exposure from derivative transactions with affiliates includes, at a minimum, imposing appropriate credit limits, mark-to market or fair value requirements, and collateral requirements.

q. Determine that the limits and requirements reflect the nature, volume, and complexity of the bank’s derivatives transactions.

r. Determine that the limits and requirements on credit exposures from derivative transactions have been approved by the board of directors of the bank or an appropriate board committee.

s. Determine that the bank’s program for monitoring and controlling the credit exposure from intraday extensions of credit to affiliates includes, at a minimum, imposing appropriate credit limits (on a per-affiliate and aggregate basis) and collateral requirements.

t. Determine that that the limits and requirements imposed by the bank reflect the volume of intraday credit transactions and the reasons for those transactions.

u. Determine that the limits and requirements on intraday credit transactions have been approved by the board of directors of the bank or an appropriate board committee.

2. *Section 23B of the Federal Reserve Act (12 USC 371c-1), Restrictions on Transactions with Affiliates, and the Board’s Regulation W*

a. Determine that covered transactions with affiliates comply with the restrictions in section 23B.

b. If the bank has derivative transactions with affiliates, determine that the bank has treated the affiliate no better than a similarly situated nonaffiliate.

c. Determine that management and other fees paid by the bank have a direct relationship to the value of the actual goods and services rendered, based on reasonable costs consistent with current market values for such goods and services.
d. Review any mortgage banking activity and servicing contracts with affiliates, if applicable. Give particular attention to—
   - the capacity in which the affiliate is acting,
   - the nature of the services provided,
   - the billing arrangement, frequency of billing, method of computation, and the basis for fees,
   - the method of compensating the bank for balances maintained and net interest earned on warehouse loans and lines of credit (This method should not be preferential.),
   - the pricing of loan and servicing-right sales,
   - advertising restrictions (for noncompliance).

INTRODUCTION

The examination of bank-related organizations must be of sufficient scope to determine a bank's compliance with laws and to evaluate its investments through an appraisal of related organizations' assets, earnings, management, and operations. In addition, the examination must fully disclose the nature of the relationships between the bank and its related organizations, as well as the effects of these relationships on the operations and safety and soundness of the bank.

FORMS OF RELATED ORGANIZATIONS

Various laws, rulings, and regulations have permitted banks to expand their services by forming or acquiring related organizations. Examples include

- the purchase for its own account, shares of a corporation that performs functions that the bank is empowered to perform directly; and
- authorization by specific laws to invest in various statutory subsidiaries, including Edge Act subsidiaries and agreement corporations.

In addition, a bank also may be controlled by an individual or company that controls other bank or nonbank entities. Regardless of the legal organizational structure between a bank and a related organization, a sound financial and satisfactory management relationship between both groups is essential to the bank's operation. Related organizations may assume several forms, as described in this section. Section 23A and 23B of the Federal Reserve Act (FRA) define the relationship between banks and affiliates.[1]

Affiliates

Affiliates are defined in subsection (b)(1) of section 23A of the FRA. Generally an affiliate is a company that is under common control with the bank. In addition, section 23A specifically states that certain entities are not considered affiliates of a member bank. See this manual's section entitled, "Transactions Between Member Banks and Their Affiliates," regarding the detailed provisions of section 23A and section 23B of the FRA, and Regulation W.

1. See 12 USC 371c and c-1.

Operations Subsidiaries

The Board has authorized member banks to establish and own operations subsidiaries. "Operations subsidiaries" are bank subsidiaries that engage in activities in which the bank could otherwise engage directly.

Member Bank Purchases of Stock of Operations Subsidiaries

The Board concluded in 1968 that "...a member bank may purchase for its own account shares of a corporation to perform, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly" (12 CFR 250.141(i)). The Board reasoned that this authority could reasonably be interpreted as within a bank's incidental powers to ''organize its operations in the manner that it believes best facilitates the performance thereof,'' and that the subsidiary essentially constitutes a separately incorporated division or department of the bank.

No specific rule requires a state member bank to give the Board prior notice of, or to acquire the Board's approval for, the acquisition of an operations subsidiary to engage in activities that the bank itself may perform lawfully. However, section 208.3(d)(2) of Regulation H (12 CFR 208.3(d)(2)) prohibits a state member bank from causing or permitting a change in the general character of its business or in the scope of its corporate powers approved at the time of admission to membership, except with the permission of the Board.

Transactions between a State Member Bank and Its Operations Subsidiary

In general, section 23A exempts covered transactions between a bank and its operating subsidiary. In general, an operating subsidiary is a subsidiary that engages in activities that the bank can engage directly or are specifically authorized by federal law.

Operations Subsidiary Not Wholly Owned

The previously mentioned 1968 interpretation only expressly authorized state member banks to establish wholly owned operations subsidiaries in that a wholly owned subsidiary of a bank is functionally indistinguishable from a division or department of the bank. In enacting the Gramm-Leach-Bliley Act (GLB Act), Congress recognized the authority of national and state member banks to own and control an operations subsidiary. The GLB Act recognized traditional operations subsidiaries by distinguishing them from financial subsidiaries. The definition of financial subsidiary excludes a company engaged solely in activities that a parent bank may perform, subject to the limitations that govern the conduct of these activities.

The GLB Act also does not require that a state member bank own 100 percent of an operations subsidiary or a financial subsidiary. The GLB Act defines the term "subsidiary" by reference to the Bank Holding Company (BHC) Act. Under the BHC Act, a company is a "subsidiary" of a bank holding company if the BHC (1) owns or controls 25 percent or more of the company's voting shares or (2) controls the election of a majority of the company's directors.[2]

The Board thus believes that, as a result of the GLB Act and consistent with section 5136 of the Revised Statutes (12 USC 24 (Seventh)) and the Board's 1968 interpretation, a state member bank may acquire shares of a company that is not wholly owned and that (1) on consummation of the acquisition would be a subsidiary of the bank within the meaning of the BHC Act, and (2) engages only in activities in which the parent bank may engage, at locations at which the bank may engage in the activities, subject to the same limitations as if the bank were engaging in the activities directly.

2. See 12 USC 1841(d). A company also is considered a subsidiary of a bank holding company if the Board determines, after notice and opportunity for a hearing, that the bank holding company directly or indirectly exercises a controlling influence over the management or policies of the company.

FINANCIAL SUBSIDIARIES

Qualifying state member banks may control or hold an interest in a "financial subsidiary." A financial subsidiary is any company that is controlled by one or more insured depository institutions and engages in activities that are financial in nature or incidental to a financial activity. A financial subsidiary does not include (1) a subsidiary that the state member bank is specifically authorized to hold by the express terms of federal law (other than by section 9 of the FRA), such as an Edge Act subsidiary held under section 25 of the FRA, or (2) a subsidiary that engages only in activities that the parent bank could conduct directly and that are conducted on the same terms and conditions that govern the conduct of the activity by the state member bank. Financial subsidiaries are authorized for national banks by section 5136A of the Revised Statutes (12 USC 24a) and for state banks by section 46 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831w). To implement the authorization for state member banks, a new subpart G was added to Regulation H (12 CFR 208.71 et seq.).

Investing in or Controlling a Financial Subsidiary

Under the GLB Act, a state member bank may control, or hold an interest in, a financial subsidiary only if

- the state member bank and each of its depository institution affiliates are well capitalized and well managed;[3]
- the aggregate consolidated total assets of all the bank's financial subsidiaries do not exceed the lesser of 45 percent of the consolidated total assets of the bank or $50 billion;[4]
- the state member bank, if it is one of the 100

3. An institution is "well capitalized" if it meets or exceeds the capital levels designated by the institution's appropriate federal banking agency (section 38 of the FDI Act (12 USC 1831o)). A depository institution will be deemed "well managed" by references to specific examination ratings, or if the depository institution has not been examined by its federal or state banking agency and its federal banking agency determines that the existence and use of managerial resources are satisfactory (see 12 CFR 208.77(h)(ii)).

4. This dollar amount will be adjusted based on an indexing mechanism that is established jointly by the Federal Reserve Board and the Secretary of the Treasury.

largest insured banks, meets the following debt-rating or alternative debt-rating requirements:

— for the 50 largest insured banks, the bank must have at least one issue of outstanding eligible debt that is currently rated in one of the three highest investment-grade rating categories by a nationally recognized statistical rating organization;[5]
— for the next 50 largest insured banks, the bank must meet the issuer-credit-rating requirement for the 50 largest insured banks or the bank must meet the alternative criteria established jointly by regulation by the Secretary of the Treasury and the Federal Reserve[6] (the debt-rating and alternative criteria are not applicable if the bank's financial subsidiaries engage in any newly authorized financial activities solely as agent and not as principal); and

• the state member bank obtains the Federal Reserve's approval to engage in the activities of the financial subsidiary (using the notice procedures in section 208.76 of Regulation H). The state member bank also must obtain any necessary approvals from its state supervisory authority.

Issuer-Credit-Rating Requirement

The issuer-credit-rating requirement of Regulation H (12 CFR 208.71(b)(ii)) requires a long-term issuer credit rating from a nationally recognized statistical rating organization that is within the three highest investment-grade rating categories used by the organization. An "issuer credit rating" is one that assesses the bank's overall capacity and willingness to pay, on a timely basis, its unsecured financial obligations. An issuer credit rating differs from a debt rating in that it does not assess the bank's ability or willingness to make payments on any individual class or issue of debt, nor does it reflect payment priority or payment preferences among financial obligations.

5. "Eligible debt" refers to unsecured debt that has an initial maturity of more than 360 days. The debt must be issued and outstanding, may not be supported by any form of credit enhancement, and may not be held in whole or any significant part by affiliates or insiders of the bank or by any other person acting on behalf of or with funds from the bank or an affiliate.

6. The size of an insured bank is determined based on the consolidated total assets of the bank as of the end of each calendar year.

Under Regulation H, the issuer credit rating must be assigned to the national or state member bank that controls or holds an interest in a financial subsidiary if the bank is subject to section 208.71(b)(ii) of Regulation H. Issuer credit ratings that are assigned to a subsidiary or affiliate of the parent bank, such as a subsidiary engaged in derivatives activities, do not meet the regulation's requirements. Rating organizations may issue long-term or short-term issuer credit ratings for the same bank and separate ratings for dollar-denominated and foreign-currency-denominated obligations. Only long-term issuer ratings for dollar-denominated obligations satisfy the requirements of the regulation. A "long-term credit rating" is a written opinion that is issued by a nationally recognized statistical rating organization regarding the bank's overall capacity and willingness to pay on a timely basis its unsecured, dollar-denominated financial obligations maturing in no less than one year.

Prudential Standards

A state member bank that owns a financial subsidiary must comply with certain prudential safeguards. These standards pertain to the bank's capital requirements and its establishment of policies and procedures arising from financial subsidiary ownership.

As for the capital requirements, the state member bank must "deconsolidate" the assets and liabilities of all of its financial subsidiaries from those of the bank. Although the GLB Act requires a bank to deconsolidate the assets and liabilities of any financial subsidiary for regulatory capital purposes, a financial subsidiary remains a subsidiary of a state member bank. The Board will continue to review the operations and financial and managerial resources of the bank on a consolidated basis as part of the supervisory process. The Board may take appropriate supervisory action if it believes that the bank does not have the appropriate financial and managerial resources (including capital resources and risk-management controls) to conduct its direct or indirect activities in a safe and sound manner.

In addition to the deconsolidation described above, the bank must also deduct a specified percentage of the aggregate amount of the equity investment (including retained earnings) ("the aggregate amount") in all financial subsidiaries from the bank's calculation of its risk-based capital, leverage, and tangible equity ratios. In particular, the bank must make the following deductions:

- 50 percent of the aggregate amount from both the bank's tier 1 capital and its tier 2 capital for purposes of determining its risk-based capital ratios;

- 50 percent of the aggregate amount from the bank's tier 1 capital for purposes of determining its leverage ratios; and

- 100 percent of the aggregate amount from its tangible equity for purposes of determining its tangible equity capital ratio. It must also deduct 100 percent of the aggregate amount from the bank's risk-weighted assets, average total assets, and total assets when determining its risk-based, leverage, and tangible capital ratios.

The bank must meet all capital requirements—including the "well-capitalized" requirement (Regulation H, section 208.71) and the capital levels established by the Board under section 38 of the FDI Act—after the adjustments described above. Beginning on January 1, 2014, for a state member bank that is an advanced approaches bank, and beginning on January 1, 2015, for all state member banks, a state member bank that controls or holds an interest in a financial subsidiary must comply with the rules set forth in §217.22(a)(7) of Regulation Q (12 CFR 217.22(a)(7)) in determining its compliance with applicable regulatory capital standards (including the well capitalized standard of section 208.71(a)(1)).

The member bank must also establish and maintain policies and procedures to manage the financial and operational risks associated with its ownership of a financial subsidiary. These procedures must identify and manage financial and operational risks with the bank and its financial subsidiaries. They must adequately protect the bank from such risks and preserve the bank's separate corporate identity and the limited liability of the bank and its financial subsidiaries. In addition, a financial subsidiary of a state member bank is considered an affiliate of the bank for purposes of sections 23A and 23B of the FRA and a subsidiary of the BHC (and not a subsidiary of a bank) for the purposes of the anti-tying prohibitions of the BHC Act Amendments of 1970.

Permissible Activities for a Financial Subsidiary

A financial subsidiary can engage in three types of permissible activities:

1. Those activities that are determined to be closely related to banking, activities determined to be usual in connection with the transaction of banking abroad, and activities that are financial in nature or incidental to financial activities under section 4(k)(4) of the BHC Act. These permissible activities include

   - general insurance agency activities in any location and travel agency activities;
   - underwriting, dealing in, and making a market in all types of securities; and
   - any activity that the Federal Reserve determined by regulation or order to be closely related to banking or managing or controlling banks so as to be a proper incident thereto and that was in effect on the effective date of the GLB Act. (See section 225.86 of the Board's Regulation Y (12 CFR 225.86).)

2. Activities that the Secretary of the Treasury, in consultation with the Board, determines to be financial in nature or incidental to financial activities and permissible for financial subsidiaries of national banks pursuant to section 5136A(b) of the Revised Statutes of the United States (12 USC 24a(b)).
3. Activities that the state member bank is permitted to engage in directly under state law, subject to the same terms and conditions that govern the conduct of the activity by the state member bank (12 USC 24a(a)(2)(A)(ii)).

Impermissible Activities for a Financial Subsidiary

As discussed in 12 CFR 208.72(b), a financial subsidiary may not engage in the following activities: (1) as principal in insurance underwriting (except to the extent permitted for national banks by the Comptroller of the Currency as of January 1, 1999, and not subsequently overturned in certain grandfathered title insurance activities); (2) providing or issuing annuities; (3) real estate investment or development (except as expressly authorized by law); and (4) merchant banking and insurance company investment activities.

Federal Reserve Approval Requirements

Federal Reserve approval of a financial subsidiary involves a streamlined notice procedure. A state member bank must file a notice with the appropriate Reserve Bank before acquiring control of, or an interest in, a financial subsidiary, or before engaging in an additional financial activity through an existing financial subsidiary. No notice is required for a financial subsidiary to engage in an additional activity that the parent state member bank could conduct directly. The notice must include basic information on the financial subsidiary and its existing and proposed activities. In the case of an acquisition, the notice should include a description of the transaction through which the bank proposes to acquire control of, or an interest in, the financial subsidiary. The notice also must contain a certification that the state member bank and its depository institution affiliates meet the capital, management, and credit-rating requirements to own a financial subsidiary, as stated in the GLB Act and subpart G of Regulation H. If the notice is for the state member bank's initial affiliation with a company engaged in insurance activities, the notice must describe the company's insurance activities and identify the states where the company holds an insurance license. A notice will be considered approved on the 15th day after receipt of a complete notice by the appropriate Reserve Bank, unless before that date, the notice is approved or denied or the bank is notified that additional time is needed to review the submitted notice.

The GLB Act permits a state member bank to acquire an interest in or control a financial subsidiary if the bank meets the criteria and requirements set forth in Regulation H. The Board, however, retains its general supervisory authority for state member banks and may restrict or limit the activities of, or the acquisition or ownership of a subsidiary by, a state member bank if the Board finds that the bank does not have the appropriate financial and managerial resources to conduct the activities or to acquire or retain ownership of the company.

AGRICULTURAL CREDIT CORPORATIONS

Most agricultural credit corporations are under the direct supervision of the district Federal Intermediate Credit Bank (FICB) where the corporations discount most of their loans. However, an agricultural credit corporation may obtain funds exclusively in the open market and avoid FICB regulation.

For agricultural credit corporations, the central point of contact or the examiner-in-charge normally decides when to examine such an entity. A complete analysis of the entity's activities should always be performed if

- the corporation is not supervised by the Federal Intermediate Credit Bank (FICB),
- the most recent FICB examination occurred over a year ago, or
- the most recent FICB examination indicates that the corporation is in less than satisfactory condition.

The extent of any analysis should be based on the examiner's assessment of the corporation's effect on the parent bank. That analysis should include, but not be limited to, a review of

- asset quality;
- the volatility, maturity, and interest-rate sensitivity of the asset and liability structures; and
- the bank's liability for guarantees issued on behalf of the corporation.

When the same borrower is receiving funds from both the corporation as well as the parent bank and the combined exposure exceeds 25 percent of total consolidated capital, the debt should be detailed on the concentration section of the examination report. The consolidation procedures listed in the instructions for the preparation of Consolidated Reports of Condition and Income should be used when consolidating the figures of the corporation with those of its parent.

EDGE ACT AND AGREEMENT CORPORATIONS

U.S.-based corporations and permissible activities for their Edge Act and agreement corporation subsidiaries are described in detail in the

Board's Regulation K (12 CFR 211 subpart A). Edge Act and agreement corporations provide banks with a vehicle for engaging in international banking or foreign financial operations. They also have the power, with supervisory consent, to purchase and hold the stock of foreign banks and other international financial concerns. Edge Act and agreement corporations are examined by the Federal Reserve, and their respective reports of examination should be reviewed during each examination of a parent member bank. The examiner should review the Federal Reserve examination report and also the amount and quality of negotiable instruments (e.g., commercial paper) held when evaluating the bank's investment in the Edge corporation.

Transactions between the parent bank and the bank's Edge Act and agreement corporation subsidiaries are not subject to the limitations in section 23A and the Board's Regulation W. However, they are subject to limitations under section 25 of the FRA (12 USC 601) and under the Board's Regulation K. In addition, transactions with such bank subsidiaries and the parent bank's affiliates are aggregated with transactions by the bank and its affiliates for purposes of section 23A limitations and restrictions. Transactions between a bank and Edge Act and agreement corporation subsidiaries of the bank's holding company are subject to section 23A.

FOREIGN BANKING ORGANIZATIONS

Under section 211.21(o) of Regulation K (12 CFR 211.21(o)), the term foreign banking organization includes

- a foreign bank, as defined in section 1(b)(7) of the International Banking Act (12 USC 3101(7)) that
  - — operates a branch, agency, or commercial lending company subsidiary in the United States;
  - — controls a bank in the United States; or
  - — controls an Edge corporation acquired after March 5, 1987; and any company of which the foreign bank is a subsidiary.

On March 15, 2006, the Board approved a revision to Regulation K (effective April 19, 2006), incorporating the provisions of section 208.63 of Regulation H by reference into sections 211.5 and 211.24 of Regulation K. Edge and agreement corporations and other foreign banking organizations (that is, U.S. branches, agencies, and representative offices of foreign banks that are supervised by the Federal Reserve) must establish and maintain procedures reasonably designed to ensure and monitor compliance with the Bank Secrecy Act and related regulations. Each of these banking organizations' compliance programs must include, at a minimum, (1) a system of internal controls to ensure ongoing compliance, (2) independent testing of compliance by the institution's personnel or by an outside party, (3) the designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance, and (4) training for appropriate personnel. (See 12 CFR part 211.)

FOREIGN BANKS

The Board's Regulation K defines a *foreign bank* in subpart A (12 CFR 211.2(j)), which governs the foreign activities of U.S banking organizations. Under subpart A, a foreign bank

- is organized under the laws of a foreign country;
- engages directly in the business of banking;
- is recognized as a bank by the bank supervisory or monetary authority of the country of its organization or principal banking operations;
- receives deposits to a substantial extent in the regular course of its business; and
- has the power to accept demand deposits.

The Board's Regulation K also defines a *foreign bank* in subpart B (12 CFR 211.21(n)), which pertains to foreign banking organizations. Under subpart B, a foreign bank

- is an organization that is organized under the laws of a foreign country;
- engages directly in the business of banking; and
- does not include a central bank of a foreign country that does not engage or seek to engage in a commercial banking business in the United States through an office.

U.S. OFFICES OF FOREIGN BANKS

Regulation K (12 CFR 211.21(t)) defines a *foreign bank office* as any branch, agency, representative office, or commercial lending company subsidiary of a foreign bank operating in the United States.

Branches of a Foreign Bank

A *branch of a foreign bank* is defined (12 CFR 211.21(e)) as any place of business of a foreign bank, located in any state, at which deposits are received, and that is not an agency.

Agencies

Regulation K (12 CFR 211.21(b)) defines an *agency* of a foreign bank as any place of business of a foreign bank, located in any state, at which credit balances are maintained, checks are paid, money is lent, or, to the extent not prohibited by state or federal law, deposits are accepted from a person or entity that is not a citizen or resident of the United States. Obligations are not to be considered credit balances unless they are

- incidental to, or arise out of the exercise of, other lawful banking powers;
- to serve a specific purpose;
- not solicited from the general public;
- not used to pay routine operating expenses in the United States such as salaries, rent, or taxes;
- withdrawn within a reasonable period of time after the specific purpose for which they were placed has been accomplished; and
- drawn upon in a manner reasonable in relation to the size and nature of the account.

Commercial Lending Company

A *commercial lending company* is defined as any organization, other than a bank or an organization operating under section 25 of the FRA (12 USC 601-604a), organized under the laws of any state, that maintains credit balances permissible for an agency and engages in the business of making commercial loans. A commercial lending company includes any company chartered under article XII of the banking law of the state of New York. (See Regulation K, section 211.21(g) (12 CFR 211.21(g)).)

Representative Office

A *representative office* is defined as any office of a foreign bank that is located in any state and is not a federal branch, federal agency, state branch, state agency, or commercial lending company subsidiary. (See section 211.21(x) of Regulation K (12 CFR 211.21(x)).) A representative office is usually established when a bank's board of directors and management desire to establish a physical presence in a foreign market and very limited functions are to be (or can be made) available. A representative office cannot provide traditional banking services, such as accepting deposits or making loans directly. The office generally serves as a liaison and marketing vehicle for the parent bank in the United States.

A U.S. subsidiary of a foreign bank may be considered to be a representative office of the foreign bank when it holds itself out to the public as a representative of the foreign bank that is acting on behalf of the foreign bank, even if the subsidiary engages in other nonbank business. In addition, an individual or a unit of a subsidiary that acts as a representative of a foreign bank from the location of the nonbank subsidiary may be treated as a representative office. A representative office may make credit decisions only if

- the foreign bank also operates one or more branches or agencies in the United States,
- the loans approved at the representative office are made by a U.S. office of the bank, and
- the loan proceeds are not disbursed in the representative office.

(See section 211.24(d)(1)(ii) of Regulation K (12 CFR 211.24(d)(1)(ii)).)

CORRESPONDENT BANKS

A correspondent bank provides certain services to banks located in other countries that do not have local offices or whose local office is prohibited from engaging in certain activities. Such a relationship allows a foreign bank to provide trade-related and foreign-exchange services for its multinational customers in a foreign market without having to establish a physical presence in that market.

PARALLEL-OWNED BANKING ORGANIZATIONS

A parallel-owned banking organization is created when at least one U.S. depository institution and a foreign bank[7] are controlled, either directly or indirectly, by the same person or group of persons[8] who are closely associated in their business dealings or otherwise acting in concert. Parallel-owned banking organizations do not include structures in which one depository institution is a subsidiary of the other or in which the organization is controlled by a company subject to the BHC Act or the Savings and Loan Holding Company Act.[9] The banking agencies[10] consider whether "control" of a depository institution exists when a person or group of persons controls 10 percent or more of any class of the depository institution's voting shares. Parallel-owned banking organizations are established and maintained for a variety of reasons, including tax and estate planning and the potential risks associated with nationalization. While these reasons may be legitimate and not prohibited by U.S. or foreign law, the structure of such organizations creates or increases certain risks and may make it more difficult for supervisors to monitor and address those risks. On April 23, 2002, the U.S. banking agencies issued a joint agency statement that addresses the potential risks associated with parallel-owned banking organizations. The existence of one or more of the following factors may, depending on the circumstances, warrant additional inquiry regarding the existence of a parallel banking organization:

- An individual or group of individuals acting in concert that controls a foreign bank also controls any class of voting shares of a U.S. depository institution, or financing for persons owning or controlling the shares that are received from, or arranged by, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan.
- The U.S. depository institution has adopted particular or unique policies or strategies similar to those of the foreign bank, such as common or joint marketing strategies, sharing of customer information, cross-selling of products, or linked websites.
- An officer or director of the U.S. depository institution either (1) serves as an officer or director[11] of a foreign bank or (2) controls a foreign bank or is a member of a group of individuals acting in concert or with common ties that controls a foreign bank.
- The name of the U.S. depository institution is similar to that of the foreign bank.

Parallel-owned banking organizations present supervisory risks similar to those arising from chain-banking organizations in the United States. The fundamental risk presented by these organizations is that they may be acting in a de facto organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision. Therefore, relationships between the U.S. depository institution and other affiliates may be harder to understand and monitor. To reduce these risks, the U.S. banking agencies (1) work with appropriate non-U.S. supervisors to better understand and monitor the activities of the foreign affiliates and owners; (2) share information, as appropriate, with foreign and domestic bank supervisory agencies; and (3) impose special conditions or obtain special commitments or representations related to an application or an enforcement or other supervisory action, when warranted.

Parallel-owned banking organizations may foster additional management and supervisory risks:

7. References to "foreign bank" or "foreign parallel bank" also include a holding company of the foreign bank and any U.S. or foreign affiliates of the foreign bank. References to "U.S. depository institution" do not include a U.S. depository institution that is controlled by a foreign bank.

8. The term "persons" includes both business entities and natural persons, which may or may not be U.S. citizens.

9. A bank holding company or savings and loan holding company, however, may be a component of a parallel-owned banking organization. This situation may arise when a bank holding company or savings and loan holding company controls the U.S. depository institution, and the holding company, in turn, is controlled by a person or group of persons who also controls a foreign bank.

10. The Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

11. The sharing of a director, by itself, is unlikely to indicate common control of the U.S. and foreign depository institutions.

- Officers and directors of the U.S. depository institution may be unable or unwilling to exercise independent control to ensure that transactions with the foreign parallel bank or affiliates are legitimate and comply with applicable laws and regulations. As a result, the U.S. depository institution may be the conduit or participant in a transaction that violates U.S. law or the laws of a foreign country, or that is designed to prefer a foreign bank or nonbank entity in the group, to the detriment of the U.S. depository institution.
- Money-laundering concerns may be heightened due to the potential lack of arm's-length transactions between the U.S. depository institution and the foreign parallel bank. Specifically, the flow of funds through wires, pouch activity, and correspondent accounts may be subject to less internal scrutiny by the U.S. depository institution than usually is warranted.[12] This risk is greatly increased when the foreign parallel bank is located in an offshore jurisdiction or other jurisdiction that limits exchange of information through bank secrecy laws, especially if the jurisdiction has been designated as a "non-cooperating country or territory" or the jurisdiction or the foreign bank has been found to be of primary money-laundering concern under the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001.
- Securities, custodial, and trust transactions may be preferential to the extent that assets, earnings, and losses are artificially allocated among parallel banks. Similarly, low-quality assets and problem loans can be shifted among parallel banks to manipulate earnings or losses and avoid regulatory scrutiny. Also, if the foreign parallel bank were to begin experiencing financial difficulties, the foreign bank or the common owners might pressure the U.S. depository institution to provide credit support or liquidity to an affiliate in excess of the legal limits of 12 USC 371c and 371c-1.
- The home country of the foreign parallel bank may have insufficient mechanisms or authority to monitor changes in ownership or to ensure arm's-length intercompany transactions between the foreign parallel bank and other members of the group, including the U.S. depository institution, or to monitor concentrations of loans or transactions with third parties that may present safety-and-soundness concerns to the group.
- Capital may be generated artificially through the use of international stock-purchase loans. Such loans can be funded by the U.S. depository institution to the foreign affiliate or to a nonaffiliate with the purpose of supporting a loan back to the foreign affiliate and used to leverage the U.S. depository institution or vice versa. This concern is heightened for parallel-owned banking organizations if the foreign bank is not adequately supervised.
- Political, legal, or economic events in the foreign country may affect the U.S. depository institution. Events in the foreign country, such as the intervention and assumption of control of the foreign parallel bank by its supervisor, may trigger a rapid inflow or outflow of deposits at the U.S. depository institution, thereby affecting liquidity. Foreign events may increase reputational risk to the U.S. depository institution. In addition, these events may adversely affect the foreign bank owner's financial resources and decrease the ability of the foreign bank owner to provide financial support to the U.S. depository institution. Foreign law may change without the U.S. depository institution or the banking agencies becoming aware of the effect of legal changes on the parallel-owned banking organization, including the U.S. depository institution.
- Parallel-owned banking organizations may seek to avoid legal lending limits or limita-

12. On October 28, 2002, the U.S. Department of the Treasury's regulation to implement sections 313 and 319(b) of the USA PATRIOT Act became effective. (See 31 CFR 1010.630 and 1010.670.) The regulation implemented new provisions of the Bank Secrecy Act that relate to foreign correspondent accounts. A covered financial institution (CFI) (a financial institution that is covered by the regulation) is prohibited from establishing, maintaining, administering, or managing a correspondent account in the United States for, or on behalf of, a foreign shell bank (a foreign bank that has no physical presence in any country) that is not affiliated with a U.S.-domiciled financial institution or with a foreign bank that maintains a physical presence in the United States or a foreign country and that is supervised by its home-country banking authority. A CFI must take reasonable steps to ensure that a correspondent account of a foreign bank (an account established by a CFI for a foreign bank to receive deposits from, to make payments or other disbursements on behalf of a foreign bank, or to handle other financial transactions related to the foreign bank) is not being used to indirectly provide banking services to foreign shell banks. The regulation includes recordkeeping requirements and required account-termination procedures that are to be used by CFIs having correspondent accounts of foreign banks. See SR-05-9 for a discussion of the PATRIOT Act's requirements for a financial institution's customer identification program. A customer identification program should be part of an institution's overall anti-money-laundering and BSA compliance program. See also the *FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual.*

tions imposed by securities or commodities exchanges or clearinghouses on transactions by one counterparty, thereby unduly increasing credit risk and other risks to the banking organizations and others.

To minimize risks, the U.S. banking agencies coordinate the supervision of a parallel-owned banking organization's U.S. operations. The supervisory approach may include unannounced coordinated examinations if more than one regulator has examination authority. Such examinations may be conducted if regulators suspect irregular transactions between parallel-owned banks, such as the shifting of problem assets between the depository institutions. Factors to consider in determining whether to conduct coordinated reviews of an organization's U.S. operations include: (1) intercompany and related transactions; (2) strategy and management of the parallel-owned banking organization; (3) political, legal, or economic events in the foreign country; and (4) compliance with commitments or representations made or conditions imposed in the application process, or conditions pursuant to prior supervisory action.

The U.S. depository institution's board of directors and senior management are expected to be cognizant of the risks associated with being part of a parallel-owned banking structure, especially with respect to diversion of a depository institution's resources, conflicts of interest, and affiliate transactions. The depository institution's internal policies and procedures should provide guidance on how personnel should interact with affiliates. The Federal Reserve and other U.S. banking agencies will expect to have access to such policies, as well as to the results of any audits of compliance with the policies. The agencies will seek an overview of the entire organization, as well as a better understanding of how foreign bank affiliates are supervised. Authorized bank regulatory supervisory staff will work with foreign supervisors to better understand the activities of the foreign affiliates and owners. As appropriate and feasible, and in accordance with applicable law, such authorized staff will share information regarding material developments with foreign and domestic supervisory agencies that have supervisory responsibility over relevant parts of the parallel-owned banking organization.

DOMESTIC AND FOREIGN SUBSIDIARIES

Domestic subsidiaries are any majority-owned companies, other than Edge Act or agreement corporations, domiciled in the United States and its territories and possessions. Foreign subsidiaries are any majority-owned or -controlled companies domiciled in a foreign country or any Edge Act or agreement corporation. Section 211.13 of Regulation K (12 CFR 211.13) requires foreign subsidiaries to maintain effective systems of records, controls, and reports to keep bank management informed of their activities and conditions. In particular, these systems are to provide information on risk assets, exposure to market risk, liquidity management, operations, internal controls, and conformance with management policies. Reports on risk assets must be sufficient enough to allow for an appraisal of credit quality and an assessment of exposure to loss; for that purpose, they must provide full information on the condition of material borrowers. Reports on the operations and controls are to include internal and external audits of the branch or subsidiary.

On-site examinations of foreign subsidiaries are sometimes precluded because of objections voiced by foreign directors, minority shareholders, or local bank supervisors. In addition, secrecy laws in some countries may preclude on-site examinations. When on-site examinations cannot be performed, foreign subsidiary reports submitted according to section 211.13 and reports submitted to foreign banking authorities must serve as the basis for evaluating the bank's investment.

Additionally, Regulation K allows for investments in foreign companies to be made under the general-consent provisions without prior approval of the Board. These investments can be sizable and can pose significant risk to the banking organization. Investments in foreign subsidiaries should be reviewed for compliance with the FRA and investment limitations in Regulation K. (See Regulation K, sections 211.8 and 211.9.)

SIGNIFICANT SUBSIDIARIES

As used in the consolidation instructions for certain regulatory reports (for example, the FR Y-11/FR Y-11S, "Financial Statements of

U.S. Nonbank Subsidiaries of U.S. Holding Companies"), "significant subsidiaries" generally refers to subsidiaries that meet any one of the following tests:

- a majority-owned subsidiary in which the bank's direct and indirect investment and advances represent 5 percent or more of the parent bank's equity capital accounts,
- a majority-owned subsidiary whose gross operating revenues amount to 5 percent or more of the parent bank's gross operating revenues,
- a majority-owned subsidiary whose "income (loss) before income taxes and securities gains or losses" amounts to 5 percent or more of the parent bank's "income (loss) before income taxes and securities gains or losses," or
- a majority-owned subsidiary that is the parent of one or more subsidiaries that, when consolidated, constitute a "significant subsidiary" as defined above.

ASSOCIATED COMPANIES

Associated companies are those in which the bank directly or indirectly owns 20 percent to 50 percent of the outstanding common stock, unless the bank can rebut to the Federal Reserve the presumption of exercising significant influence. However, as noted above, for purposes of section 23A, affiliation is defined by 25 percent share ownership. Because of the absence of direct or indirect control, regulators have no legal authority to conduct full examinations of this type of company. Investments in these companies are generally appraised in the same way as commercial loans, that is, by a credit analysis of the underlying financial information.

CHAIN-BANKING ORGANIZATIONS

Chain-banking organizations exist when an individual (or group of individuals) is a principal in two or more banking institutions, in either banks or BHCs or a combination of both types of institutions. Chain-banking organizations can also exist in savings and loan holding companies (SLHCs). In these systems, the possibility exists that problems in one or more of the entities may adversely affect the safety and soundness of the bank entities because of pressure exerted by their common principal (or principals). Examiners should determine whether the bank is a member of a chain. If so, the extent of its relationship with other links of the chain should be determined, as well as the effects these relationships have on the bank.

REAL ESTATE INVESTMENT TRUSTS AND OTHER RELATED ORGANIZATIONS

Although a bank, its parent holding company, or its nonbank affiliate may not have a direct investment in an "other related organization," the bank may sponsor, advise, or influence the activities of these companies. The most notable examples are real estate investment trusts (REITs) or special-purpose vehicles (SPVs). Transactions between the bank and REITs and between other investment companies may be subject to the limitations in section 23A and Regulation W. In other cases, because of nonownership or a less-than-majority ownership, legal authority to conduct an examination does not exist.

A REIT may be considered an affiliate if it is advised by the member bank or by any subsidiary or affiliate of the member bank. In these cases, transactions between the bank and an affiliated REIT are subject to the requirements of section 23A. Because a REIT frequently carries a name that closely identifies it with its sponsoring bank or BHC, failure of the REIT could have an adverse impact on public confidence in the holding company and its subsidiaries.

The examiner should be aware of all significant transactions between the bank under examination and its related REIT in order to determine conflicts of interest and contingent risks. In several instances, REITs have encountered serious financial problems and have attempted to avoid failure by selling questionable assets to, or swapping these assets with, their bank affiliates. In other instances, because of the adversary relationship, REITs have been encouraged to purchase assets of inferior quality from their related organizations.

HOLDING COMPANIES

As defined in section 2 of the BHC Act of 1956 (12 USC 1841 et seq.), a BHC is any company that 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 bank or company; that controls in any manner the election of a majority of the directors or trustees of the bank or company; or that the Board determines, after notice and opportunity for hearing, directly or indirectly exercises controlling influence over the management or policies of the bank or company.

The Home Owners' Loan Act (HOLA) defines an SLHC as any company that directly or indirectly controls a savings association or that controls any other company that is a savings and loan holding company. In general, a company controls a savings association if one or more persons directly or indirectly owns, controls, or has the power to vote more than 25 percent of the voting shares of the savings association, or controls in any manner the election of a majority of the directors of the savings association.

A parent holding company is considered an affiliate when the holding company controls the insured depository institution (IDI) in a manner consistent with the definition of control in section 23A of the FRA. Section 23A exempts from the quantitative and collateral requirements of the law all transactions (except for the purchase of low-quality assets) between "sister" IDIs (IDIs with 80 percent or more common ownership) by a company. A low-quality asset is any asset (1) classified "substandard," "doubtful," or "loss," or treated as "special mentioned" or "other transfer risk problems" in the most recent federal or state examination or inspection report; (2) on nonaccrual status; (3) with principal or interest payments more than 30 days past due; (4) whose terms have been renegotiated or compromised due to the deteriorated financial condition of the borrower; or (5) 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.

Under the BHC Act, the Federal Reserve has authority to inspect BHCs and their nonbank subsidiaries.[13] The Federal Reserve requires periodic inspections of all BHCs, the frequency of which is based on the size, complexity, and condition of the organization. If a BHC is inspected at the same time as the examination of its state member bank subsidiaries, the examiner at the bank should collaborate closely with inspection personnel on those holding company issues that directly affect the condition of the bank. When the BHC inspection is not conducted simultaneously with the examination, the bank examiner should closely review the most recent report of inspection and may also need to consult the FR Y-series of reports regularly submitted to the Federal Reserve System by BHCs.

Many depository institutions are owned by holding companies. To understand the effects of the holding company structure on the subsidiary IDI, the examiner should evaluate the overall financial support provided by the parent company, quality of supervision and centralized functions provided, and appropriateness of intercompany transactions. Since financial and managerial issues at the holding company and subsidiary IDI levels are so closely connected, it is strongly recommended that a holding company inspection and its respective bank examination(s) be conducted at the same time or shortly after the examination of the lead bank. A combined examination/inspection report, as discussed in SR 94-46, is available to facilitate this coordination when the lead subsidiary is a state member bank.

Financial Support

The holding company structure can provide its subsidiary IDI with strong financial support because of its greater ability to attract and shift funds to less capital-intensive areas and to enter markets in a wider geographic area than would otherwise be possible. Financial support may take the form of capital (equity or debt) or funding of loans and investments. In general, the lower the parent BHC's leverage, the more it is able to serve as a source of financial strength to its IDI subsidiaries. This is because less cash flow will be required from the IDIs for debt servicing and the parent has more borrowing capacity, which could be used to provide funds to the IDI. When the financial condition of the holding company or its nonbanking subsidiaries is unsound, the operations of its subsidiary IDI can be adversely affected. To service its debt or provide support to another subsidiary that is experiencing financial difficulty, the holding

13. Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) transfers to the Board of Governors of the Federal Reserve System the supervisory functions of the Office of Thrift Supervision related to savings and loan holding companies (SLHCs) and their nondepository subsidiaries beginning on July 21, 2011.

company may involve its IDI subsidiary in the following imprudent actions:

- engaging in high-risk investments to obtain increased yields,
- purchasing or swapping its high-quality assets for the parent's or other affiliate's lower-quality assets,
- entering into intercompany transactions that are detrimental because of inordinately high fees or inadequate or unnecessary services,
- paying excessive dividends, or
- making improper tax payments or unfavorably altering its tax situation.

Even when the holding company's structure is financially sound, the holding company's ability to sell short- or long-term debt and to pass the proceeds down to its IDI subsidiary in the form of equity capital may still present problems. This procedure is frequently referred to as "double leveraging," the amount of the equity investment in the bank subsidiary that is financed by debt. Problems may arise when the holding company must service its debt out of dividends from the subsidiary, and the subsidiary, if it encounters an earnings problem or is prevented by regulatory agreement or action, may not be able to pass dividends up to its parent.

Another potential problem may develop when the holding company sells its commercial paper and funds its subsidiary's loans with those proceeds. This may cause a liquidity problem if the maturities of the commercial paper sold and loans funded are not matched appropriately and if the volume of such funding is large in relation to the subsidiary's overall operations.

The Board's Regulation Y provides that a BHC shall serve as a source of financial and managerial strength to their subsidiary banks.[14] Regulation Y reiterates a general policy that has been expressed on numerous occasions in accordance with authority that is provided under the BHC Act and the enforcement provisions of the FDI Act. The FDI Act also requires SLHCs to act as a source of strength to their depository institution subsidiaries. See section 38A of the FDI Act and section 616(d) of the Dodd-Frank Act.

14. 12 CFR 225.4 (a)(1).

Holding Company Oversight of Subsidiaries

BHCs use a variety of methods to supervise their bank subsidiaries, including

- having holding company senior officers serve as directors on the bank's board;
- establishing reporting lines from senior bank management to corporate staff;
- formulating or providing input into key policies; and
- establishing management information systems, including internal audit and loan review.

As part of the evaluation of bank management, the examiner should be aware of these various control mechanisms and determine whether they are beneficial to the bank. Examiners should keep in mind that, even in a holding company organization, the directors and senior management of the bank are ultimately responsible for operating it in a safe and sound manner.

In addition, many bank functions (investment management, asset/liability management, human resources, operations, internal audit, and loan review) may be performed on behalf of the bank by its parent BHC or by a nonbank affiliate. These functions are reviewed at inspections of the holding company. Examiners at the bank should be aware of the evaluation of these functions by inspection personnel, either at a concurrent inspection or in the report of a prior inspection. In addition, a review of these same issues at the level of the subsidiary bank is useful to determine compliance with corporate policies, corroborate inspection findings, and identify any inappropriate transactions that may have been overlooked in the more general, top-down review at the parent level.

FINANCIAL HOLDING COMPANIES

Section 4(k) of the BHC Act authorizes affiliations among banks, securities firms, insurance firms, and other financial companies. It provides for the formation of financial holding companies (FHCs) and allows a BHC or foreign bank that qualifies as an FHC to engage in a broad range of activities that are (1) defined by the GLB Act to be financial in nature or incidental to a financial activity or (2) determined by the Board, in consultation with the secretary of the Treasury, to be financial in nature or incidental to a financial activity or that are determined by the Board to be complementary to a financial activity, which would not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Certain conditions must be met for a BHC, SLHC, or a foreign bank to be deemed an FHC and to engage in the expanded activities. BHCs that do not qualify as FHCs are limited to engaging in those nonbanking activities that are permissible under section 4(c)(8) of the BHC Act. Section 4(k) of the BHC Act authorizes an FHC to engage in designated financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities.

Supervisory Oversight

The Federal Reserve has supervisory oversight authority and responsibility for SLHCs and BHCs that operate as FHCs and for SLHCs and BHCs that are not FHCs. The GLB Act sets parameters for operating relationships between the Federal Reserve and other regulators. The GLB Act differentiates between the Federal Reserve's relations with (1) depository institution regulators and (2) functional regulators, which include insurance, securities, and commodities regulators. The Federal Reserve's relationships with functional regulators will, in practice, depend on the extent to which an FHC is engaged in functionally regulated activities; those relationships will also be influenced by existing working arrangements between the Board and the functional regulator.

The Federal Reserve's supervisory oversight role is that of an umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization. Umbrella supervision is not an extension of more traditional bank-like supervision throughout an FHC. The FHC framework is consistent with and incorporates principles that are well established for BHCs. The FHC supervisory policy focuses on addressing supervisory practice for and relationships with FHCs, particularly those that are engaged in securities or insurance activities. (See SR 00-13 and SR 14-9).

The Federal Reserve is responsible for the consolidated supervision of FHCs. The Federal Reserve thus assesses the holding company on a consolidated or group-wide basis. The objective is to ensure that the holding company does not threaten the viability of its depository institution subsidiaries. Depository institution subsidiaries of FHCs are supervised by their appropriate primary bank or thrift supervisor (federal and state). However, the GLB Act did not change the Federal Reserve's role as the federal BHC supervisor.

Nonbank (or nonthrift) subsidiaries engaged in securities, commodities, or insurance activities are to be supervised by their appropriate functional regulators. Examples of these functionally regulated subsidiaries include a broker, dealer, investment adviser, and investment company registered with and regulated by the Securities and Exchange Commission (SEC) (or, in the case of an investment adviser, registered with any state); an insurance company or insurance agent subject to supervision by a state insurance regulator; and a nonbank subsidiary engaged in activities regulated by the Commodity Futures Trading Commission (CFTC).

As the umbrella supervisor, the Federal Reserve will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions. Oversight of FHCs (particularly those engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with an FHC's activities can cut across legal entities and business lines. The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company to assess how these risks might affect the safety and soundness of depository institution subsidiaries.

The Federal Reserve's focus will be on the financial strength and stability of FHCs, their consolidated risk-management processes, and overall capital adequacy. The Federal Reserve will review and assess internal policies, reports, and procedures, as well as the effectiveness of the FHC consolidated risk-management process. The appropriate bank, thrift, or functional regulator will continue to have primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity or entities that it supervises.

Permissible Activities

Permissible activities for FHCs include any activity that the Board determined to be closely related to banking under section 4(c)(8) of the BHC Act by regulation that was in effect prior to November 12, 1999, or by order that was in effect on November 12, 1999. This includes the long-standing "laundry list" of nonbanking activities for BHCs. (See section 225.28(b) of Regulation Y.) Section 225.86(a)(2) of Regulation Y lists the nonbanking activities approved for BHCs by Board order as of November 12, 1999.[15]

Section 4(k)(4)(G) of the BHC Act also defines "financial in nature" as any activity (1) in which a BHC may engage outside the United States and (2) that the Board has determined, by regulation or interpretations issued under section (4)(c)(13) of the BHC Act that were in effect on November 11, 1999, to be usual in conducting banking or other financial services abroad. Section 225.86(b) of Regulation Y lists three activities that the Board has found to be usual in connection with the transaction of banking or other financial operations abroad.[16] The activities are (1) providing management consulting services; (2) operating a travel agency; and (3) organizing, sponsoring, and managing a mutual fund. The conduct of each activity has certain prescribed limitations. Management consulting services must be advisory and not allow the FHC to control the person to whom the services are provided. These services, however, may be offered to any person on nonfinancial matters. An FHC may also operate a travel agency in connection with financial services offered by the FHC or others. Finally, a mutual fund organized, sponsored, or managed by an FHC may not exercise managerial control over the companies in which the fund invests, and the FHC must reduce its ownership of the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund (or within such additional period as the Board permits).

The activities that a BHC is authorized to engage in outside the United States under section 211.10 of Regulation K have been either (1) authorized for FHCs in a broader form by the GLB Act (for example, underwriting, distributing, and dealing in securities and underwriting various types of insurance) or (2) authorized in the same or a broader form in Regulation Y (for example, data processing activities; real and personal property leasing; and acting as agent, broker, or adviser in leasing property). Section 4(k)(4)(G) of the BHC Act and section 225.86 of Regulation Y only authorize FHCs to engage in the activities that are listed in section 211.10 of Regulation K, as interpreted by the Board. The Board has also approved activities found in individual orders issued under section 4(c)(13) of the BHC Act. Section 4(k)(4)(G) and Regulation Y do not authorize an FHC to engage in activities that the Board authorized a BHC to provide in individual orders issued under section 4(c)(13) of the BHC Act.

The remaining activities authorized by section 4(k)(4) of the BHC Act are those that are defined to be "financial in nature" under section 4(k)(4)(A) through (E), (H), and (I). (See section 225.86(c) of Regulation Y.) These activities include issuing annuity products and acting as principal, agent, or broker for purposes of insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death. Permissible insurance activities as principal include reinsuring insurance products. An FHC acting under section 4(k)(4) of the BHC Act may conduct insurance activities without regard to the restrictions on the insurance activities imposed on BHCs under section 4(c)(8). (See section 3905.0 of the *Bank Holding Company Supervision Manual* for more information pertaining to the activities of FHCs.)

INTERCOMPANY TRANSACTIONS

As with the supervision of subsidiaries, intercompany transactions should be reviewed at both the parent level during inspections and at the subsidiary-bank level during examinations. The transactions should comply with sections 23A and 23B of the FRA, Regulation W, and should not otherwise adversely affect the financial condition of the bank.

15. Section 20 company activities are not included in this list. Section 4(k)(4)(E) of the BHC Act authorizes FHCs to engage in securities underwriting, dealing, and market-making activities in a broader form than was previously authorized by Board order.

16. See section 211.10 of Regulation K (12 CFR 211.10).

Intercompany Tax Payments

SR letter 98-38, "Interagency Policy Statement on Tax Allocation in a Holding Company Structure," provides guidance to banking organizations and savings associations regarding the allocation and payment of taxes among a holding company and its subsidiaries. A holding company and its depository institution subsidiaries will often file a consolidated group income tax return. However, each depository institution is viewed as, and reports as, a separate legal and accounting entity for regulatory purposes. Accordingly, each depository institution's applicable income taxes, reflecting either an expense or benefit, should be recorded as if the institution had filed on a separate entity basis. Furthermore, the amount and timing of payments or refunds should be no less favorable to the subsidiary than if it were a separate taxpayer. The 2014 addendum to the policy statement provides that the holding company is acting as an agent on behalf of its IDIs when it relates to tax allocation within the company. See 79 *Fed. Reg.* 35338 (June 19, 2014) and SR 14-6.

Management and Other Fees

IDIs often obtain goods and services from the parent holding company or an affiliated nonbank subsidiary. These arrangements may benefit the IDI, since the supplier may offer lower costs because of economies of scale, such as volume dealing. Furthermore, IDIs may be able to purchase a package of services that otherwise might not be available. However, because of the relationship between the IDI and the supplier, examiners should ensure that the fees being paid represent reasonable reimbursement for goods and services received. Fees paid by the IDI to the parent or nonbank affiliates should have a direct relationship to, and be based solely on, the fair value of goods and services provided. Fees should compensate the affiliated supplier only for providing goods and services that meet the legitimate needs of the IDI.

IDIs should retain satisfactory records that substantiate the value of goods and services received, their benefit to the IDI, and their cost efficiencies. There are no other minimum requirements for records, but an examiner should be able to review the records maintained and determine that fees represent reasonable payment. In general, the supplier will decide on the amount to be charged by the comparative free-market value of the services.

When the servicer incurs overhead expenses, recovery of those costs is acceptable to the extent they represent a legitimate and integral part of the service rendered. Overhead includes salaries and wages, occupancy expenses, utilities, payroll taxes, supplies, and advertising. Debt-service requirements of holding companies, shareholders, or other related organizations are not legitimate overhead expenses for a subsidiary bank.

Generally, the payment of excessive fees is considered an unsafe and unsound practice and is a violation of section 23B of the FRA and the Board's Regulation W. When fees are not justified, appear excessive, do not serve legitimate needs, or are otherwise abusive, the examiner should inform the board of directors through appropriate criticism in the report of examination.

Dividends

Dividends represent a highly visible cash outflow by banks. If the dividend-payout ratio exceeds the level at which the growth of retained earnings can keep pace with the growth of assets, the bank's capital ratios will deteriorate. Examiners should evaluate the appropriateness of dividends relative to the bank's financial condition, prospects, and asset-growth forecast.

Purchases or Swaps of Assets

Asset purchases or swaps between IDIs and their affiliates create the potential for abuse. Regulatory concern focuses on the fairness of such asset transactions, their financial impact, and timing. Fairness and financial considerations include the quality and collectibility of such assets and liquidity effects. Asset exchanges may be a mechanism to avoid regulations designed to protect subsidiary banks from becoming overburdened with nonearning assets. Most asset purchases by an IDI from an affiliate are subject to sections 23A and 23B of the FRA.

Compensating Balances

A subsidiary bank may be required to maintain excess balances at a correspondent bank that lends to other parts of the holding company organization, possibly to the detriment of the bank. The subsidiary bank may be foregoing earnings on such excess funds, which may adversely affect its financial condition.

Split-Dollar Life Insurance

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, or death benefit, or both. In some circumstances, when the subsidiary bank pays all or substantially all of the insurance premiums, an unsecured extension of credit from the bank to its parent holding company generally results because the bank has paid the holding company's portion of the premium, and the bank will not be fully reimbursed until later. In other arrangements, when the parent uses the insurance policy as collateral for loans from the subsidiary bank, the loan may not meet the collateral requirements of section 23A or Regulation W. In addition, split-dollar arrangements may not comply with section 23B or Regulation W if the return to the bank is not commensurate with the size and nature of its financial commitment. Finally, split-dollar arrangements may be considered unsafe and unsound, which could be the case if the bank is paying the entire premium but is not the beneficiary of the policy, or if it receives less than the entire proceeds of the policy. This type of transaction may also result in a violation of the Board's Regulation W. (See SR 93-37, "Split-Dollar Life Insurance.")

Other Transactions with Affiliates

Checking accounts of the parent or nonbank subsidiaries at subsidiary banks present the potential for overdrafts, which are regarded as unsecured extensions of credit to an affiliate by the subsidiary bank, and are in violation of section 23A of the FRA. In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts of the holding company organization. In addition, a subsidiary bank should not pay for expenses for which it does not receive a benefit (for example, the formation expenses of a BHC or SLHC).

Situations sometimes arise in which more than one legal entity in a banking organization shares offices or staff. In certain cases, it can be hard to determine whether a legal entity is operating within the scope of its permissible activities. In addition, a counterparty may be unclear as to which legal entity an employee is representing. Finally, there may be expense-allocation problems and, thus, issues pertaining to sections 23A and 23B of the FRA or Regulation W. Examiners should be aware of these concerns and make sure that institutions have the proper records and internal controls to ensure an adequate separation of legal entities. (See SR 95-34 "Sharing of Facilities and Staff by Banking Organizations.")

EVALUATION OF INVESTMENTS IN AND LOANS TO BANK-RELATED ORGANIZATIONS

To properly evaluate affiliates and other bank-related organizations[17] relative to the overall condition of the bank, the examiner must

- know the applicable laws and regulations that define and establish limitations with respect to investments in, and extensions of credit to, affiliates and
- analyze thoroughly the propriety of the related organizations' carrying value, the nature of the relationships between the bank and its related organizations, and the effect of such relationships on the affairs and soundness of the bank.

The propriety of the carrying value of a bank's investment in any related organization is determined by evaluating the balance sheet and income statement of the company in which the bank has the investment. At times, this may not

17. Information about related organizations and interlocking directorates and officers can be obtained from the bank holding company form FR Y-6 and SEC form 10-K, if applicable, or from other required domestic and foreign regulatory reports. Further information on business interests of directors and principal officers of the bank can be obtained by reviewing information maintained by the bank in accordance with the Board's Regulation O.

seem important in relation to the overall condition of the bank because the amount invested may be small relative to the bank's capital. It may appear that a cursory appraisal of the company's assets would therefore be sufficient. However, the opposite is often true. Even though a bank's investment in a subsidiary or associated company is relatively small, the underlying fiduciary or compliance obligations may be substantial and may greatly exceed the total amount of the reported investment. If the subsidiary experiences large losses, the bank may have to recapitalize the subsidiary by injecting much more than its original investment to protect unaffiliated creditors of the subsidiary or protect its own reputation.

When examining and evaluating the bank's investment in and loans to related organizations, classified assets held by such companies should first be related to the capital structure of the company and then be used as a basis for classifying the bank's investment in and loans to that company.

One problem that examiners may encounter when they attempt to evaluate the assets of some subsidiaries and associated companies is inadequate on-premises information. This may be especially true of foreign investments and associated companies in which the bank has less than a majority interest. In those instances, the examiner should request that adequate information be obtained during the examination and should establish agreed-on standards for that information in the future. The examiner should insist that the organization have adequate supporting information readily obtainable or available in the bank and that the information be of sufficient quality to allow for an informed evaluation of the investment. Bank management, as well as regulatory authorities, must be adequately informed of the condition of the companies in which the bank has an investment. For subsidiary companies, it is necessary that bank representatives be a party to policy decisions, have some on-premises control of the company (such as board representation), and have audit authority. In the case of an associated company, the bank should participate in company affairs to the extent practicable. Information documenting the nature, direction, and current financial status of all such companies should be maintained at the bank's head office or maintained regionally for global companies. Full audits by reputable certified public accountants are often used to provide much of this information.

For foreign subsidiaries, in addition to the audited financial information prepared for management, the bank should have on file the following:

- reports prepared according to the Board's Regulation K;
- reports prepared for foreign regulatory authorities;
- information on the country's regulatory structure, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, and fiscal policy, political goals, and a determination as to the potential risk of expropriation; and
- adequate information to review compliance with the investment provisions of Regulation K. (For each investment, information should be provided on the type of investment (equity, binding commitments, capital contributions, subordinated debt), dollar amount of the investment, percentage ownership, activities conducted by the company, legal authority for such activities, and whether the investment was made under Regulation K's general-consent, prior-notice, or specific-consent procedures. With respect to investments made under the general-consent authority, information also must be maintained that demonstrates compliance with the various limits set out in section 211.9 of Regulation K. (See Regulation K, sections 211.8 and 211.9.)

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Related Organizations

INTERAGENCY POLICY ON BANKS AND THRIFTS PROVIDING FINANCIAL SUPPORT TO FUNDS ADVISED BY THE BANKING ORGANIZATION OR ITS AFFILIATES

On January 5, 2004, the federal banking agencies[1] (the agencies) issued an interagency policy statement to alert banking organizations, including their boards of directors and senior management, of the safety-and-soundness implications of, and the legal impediments to, a bank providing financial support to investment funds[2] advised by the bank, its subsidiaries, or affiliates (affiliated investment funds). A banking organization's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation and can harm investors, if the associated risks are not effectively controlled. (See SR-04-1.)

Banks are under no statutory requirement to provide financial support to the funds they advise; however, circumstances may motivate banks to do so for reasons of reputation risk and liability mitigation. This type of support by banking organizations to funds they advise has included credit extensions, cash infusions, asset purchases, and the acquisition of fund shares. In very limited circumstances, certain arrangements between banks and the funds they advise have been expressly determined to be legally permissible and safe and sound when properly conducted and managed. However, the agencies are concerned about other occasions when emergency liquidity needs may prompt banks to support their advised funds in ways that raise prudential and legal concerns. Federal laws and regulations place significant restrictions on transactions between banks and their advised funds. In particular, sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W (12 CFR 223) place quantitative limits and collateral and market-terms requirements on many transactions between a bank and certain of its advised funds.

1. The Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS). Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act) abolished the OTS, which had been responsible for regulating state and federal savings associations and their holding companies. See 12 U.S.C 5413 (Dodd-Frank Act 313). The OTS's functions and powers were transferred to the OCC, FDIC, and the Board. The Board acquired regulatory and rulemaking authority over savings and loan holding companies. See 12 U.S.C. 5412 (Dodd-Frank Act 312). The OCC acquired supervisory and rulemaking authority over federal savings associations. The FDIC acquired supervisory and rulemaking authority over state-chartered savings associations.

2. Bank-advised investment funds include mutual funds, alternative strategy funds, collective investment funds, and other funds where the bank, its subsidiaries, or affiliates is the investment adviser and receives a fee for its investment advice. For purposes of the guidance, "banks" includes banks and savings associations.

Interagency Policy

To avoid engaging in unsafe and unsound banking practices, banks should adopt appropriate policies and procedures governing routine or emergency transactions with bank-advised investment funds. Such policies and procedures should be designed to ensure that the bank will *not* (1) inappropriately place its resources and reputation at risk for the benefit of the funds' investors and creditors; (2) violate the limits and requirements contained in sections 23A and 23B of the Federal Reserve Act and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or (3) create an expectation that the bank will prop up the advised fund. Further, the agencies expect banking organizations to maintain appropriate controls over investment advisory activities that include:

- Establishing alternative sources of emergency support from the parent holding company, nonbank affiliates, or external third parties prior to seeking support from the bank.
- Instituting effective policies and procedures for identifying potential circumstances triggering the need for financial support and the process for obtaining such support. In the limited instances that the bank provides financial support, the bank's procedures should include an oversight process that requires formal approval from the bank's board of directors, or an appropriate board-designated committee, independent of the investment advisory function. The bank's audit committee also should review the transaction to

ensure that appropriate policies and procedures were followed.

- Implementing an effective risk-management system for controlling and monitoring risks posed to the bank by the organization's investment advisory activities. Risk controls should include establishing appropriate risk limits, liquidity planning, performance measurement systems, stress testing, compliance reviews, and management reporting to mitigate the need for significant bank support.
- Implementing policies and procedures that ensure that the bank is in compliance with existing disclosure and advertising requirements to clearly differentiate the investments in advised funds from obligations of the bank or insured deposits.
- Ensuring proper regulatory reporting of contingent liabilities arising out of its investment advisory activities in the banking organization's published financial statements in accordance with Accounting Standards Codification subtopic 450-20, Contingencies: Loss Contingencies, and fiduciary settlements, surcharges, and other losses arising out of its investment advisory activities in accordance with the instructions for completing Call Report Schedule RC-T (Fiduciary and Related Services).

Notification of a Banking Organization's Primary Federal Regulator

Because of the potential risks posed by the provision of financial support to advised funds, bank management should notify and consult with its appropriate federal banking agency prior to the bank providing material financial support to its advised funds. The appropriate federal banking agency will closely scrutinize the circumstances surrounding the transaction and will address situations that raise supervisory concerns.

1. To determine if the bank provides support to an advised fund and, if so, the type of support that is being provided.
2. If the bank is providing support to an advised fund, to ascertain whether the type of support raises prudential (safety-and-soundness) or legal concerns, such as noncompliance with sections 23A and 23B of the Federal Reserve Act, and with Regulation W.
3. To determine whether the bank has adopted appropriate policies and procedures governing routine or emergency transactions with funds that it advises.
4. To find out if the bank has established appropriate controls over investment advisory activities.
5. If a bank has provided material financial support to an advised fund, to determine if the bank notified its primary federal regulator before engaging in the activity.

1. Determine if the bank has inappropriately placed its resources at risk for the benefit of an affiliated investment fund's investors and creditors.
2. Ascertain whether the bank's advisory services to investment funds pose material risks to the bank's liquidity, earnings, and capital.
3. Determine if the bank provides support to an investment fund and if that support violates the limits and requirements of sections 23A and 23B of the Federal Reserve Act, and Regulation W; other applicable legal requirements; or any special supervisory condition imposed by the bank's primary federal supervisory agency.
4. Find out if the bank has given any form of assurances or expectations that it will provide financial or other support to an advised fund.
5. Ascertain whether the bank has established appropriate controls over investment advisory activities, such as:
   a. Establishing alternative sources of emergency support that can be made available to an advised fund from the parent holding company, nonbank affiliates, or external third parties before the fund seeks financial support from the bank.
   b. Instituting effective policies and procedures to—
      - identify potential circumstances that would trigger the need for financial support by an affiliated fund, and establish the process for obtaining that support;
      - ensure that the bank is in compliance with existing disclosure and advertising requirements that clearly differentiate the investments in advised funds from the bank's other obligations or federally insured deposits; and
      - avoid unsafe and unsound banking practices by initiating procedures that govern routine or emergency transactions with bank-advised investment funds.
   c. Implementing an effective risk-management system for controlling and monitoring risks posed to the bank by its investment advisory activities.
   d. Ensuring the bank's proper reporting, in its financial statements, of contingent liabilities that arise out of its investment advisory activities.
6. Determine if the bank notified and consulted with the appropriate supervising Federal Reserve Bank before providing financial support to an affiliated investment fund.

Review the bank's internal controls, policies, practices, and procedures concerning investment funds that it advises. When performing that task, conduct examination reviews and procedures to answer the following questions:

1. Has the bank—
   a. inappropriately placed its financial resources at risk for the benefit of affiliated investment funds' investors and creditors?
   b. violated the limits and requirements in sections 23A and 23B of the Federal Reserve Act and in Regulation W, with regard to its transactions with advised investment funds?
   c. created any expectation that the bank will prop up an advised fund?
2. Do the bank's advisory services pose material risks to its liquidity, earnings, and capital?
3. Does the bank encourage its advised investment funds to establish alternative sources of financial support so that the funds can avoid seeking support from the bank itself?
4. Has the bank provided support to the funds it advises, such as with extensions of credit, cash infusions, asset purchases, acquisition of fund shares, or any other type of financial support?
5. Has the bank implemented and maintained an effective risk-management system for controlling and monitoring the risks posed to the bank by its investment advisory activities?
6. Did the bank's board of directors adopt appropriate policies and procedures to avoid engaging in unsafe and unsound banking practices with respect to routine or emergency transactions with bank-advised investment funds?
7. Has the bank's management properly reported contingencies arising out of its investment advisory activities, in accordance with Accounting Standards Codification subtopic 450-20, Contingencies: Loss Contingencies, and also any fiduciary settlements, surcharges, and other losses arising out of its investment advisory activities, in accordance with the instructions of the bank Call Report Schedule RC-T (Fiduciary and Related Services)?
8. Has the bank's management notified and consulted with its appropriate supervising Federal Reserve Bank before providing material financial support to advised funds?

INTRODUCTION

Among other things, section 106 of the Bank Holding Company Act Amendments of 1970 (section 106) prohibits a bank from conditioning the availability or price of one product on a requirement that the customer also obtain another product from the bank or an affiliate of the bank.[1] The statute is intended to prevent banks from using their ability to offer bank products in a coercive manner to gain a competitive advantage in markets for other products and services.[2] Tying arrangements that are prohibited by section 106 may be addressed by the bank's appropriate federal banking agency through an enforcement action, by the Department of Justice through a request for an injunction, or by a customer or other person injured by the tying arrangement through a request for an injunction or a legal action against the bank for damages.[3]

Although section 106 prohibits banks from imposing certain types of tying arrangements on their customers, the statute also expressly permits banks to engage in other forms of tying and authorizes the Board to grant additional exceptions to the statute's prohibitions by regulation or order.

PROHIBITIONS UNDER SECTION 106

Section 106 prohibits a bank from extending credit, leasing or selling property, furnishing any service, or fixing or varying the consideration for any of the foregoing on the condition or requirement that a customer

- obtain some additional credit, property, or service from the bank or its affiliates other than a loan, discount, deposit, or trust service;
- provide some additional credit, property, or service to the bank or its affiliates, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service; or
- not obtain some additional credit, property, or service from a competitor of the bank or of an affiliate of the bank unless the condition is reasonably imposed in a credit transaction to assure the soundness of the credit.[4]

The most common types of tying arrangements are those where a bank product or consideration for a bank product to a customer is conditioned upon the customer obtaining another product from the bank or an affiliate. There are two elements necessary to establish an impermissible tying arrangement under these circumstances: (1) the arrangement must involve two or more separate products and (2) the customer is, in fact, required to buy a tied product in order to get a tying product.

APPLICABILITY OF SECTION 106

Section 106 applies only to tying arrangements that are imposed by a bank, whether or not they are subsidiaries of holding companies. The statute does not apply to tying arrangements imposed by affiliates of the bank. However, an examination of the facts and circumstances of a tying arrangement imposed by a bank affiliate that involves a bank product could reveal that the arrangement essentially is a tying arrangement set forth by the bank, but structured to appear as though it is required by the bank affiliate. These arrangements may constitute prohibited tying arrangements.

Section 106 specifically allows a bank to engage in a tying arrangement if the tied product is a "loan, discount, deposit, or trust service" (a "traditional bank product" provided to a customer).[5] The Board has not clarified the scope of this exception.

A parallel provision, codified in section 5(q) of the Home Owners' Loan Act of 1933, applies to savings associations and is also administered by the Board.[6]

1. 12 U.S.C. 1972. Although part of the Bank Holding Company Act Amendments of 1970, section 106 applies to a bank whether or not the bank is owned or controlled by a bank holding company.
2. Banks and their affiliates, including nonbank affiliates, are also subject to the tying restrictions contained in the federal antitrust laws (the Sherman and Clayton Acts). 15 U.S.C. 1 et seq.; 15 U.S.C. 12 et seq.
3. 12 U.S.C. 1972, 1973, 1975, and 1976.
4. 12 U.S.C. 1972(1).
5. 12 U.S.C. 1972(1)(A). Products or services in the form of a "loan, discount, deposit, or trust service" are considered to be traditional bank products.
6. 12 U.S.C. 1464(q).

EXCEPTIONS TO SECTION 106

Section 106 expressly permits a bank to condition the availability or price of a product on a requirement that the customer also obtain a loan, discount, deposit or trust service from the bank. The statute also expressly permits a bank to condition the availability or price of a product on a requirement that the customer provide the bank with some additional product that is related to and usually provided in connection with a loan, discount, deposit, or trust service. Mixed-product arrangements—or arrangements whereby bank customers can receive a discount if they choose several products among a larger menu of products—may or may not violate section 106 depending on the facts and circumstances.

In addition to the statutory exceptions set forth in section 106, additional regulatory exceptions can be found in the Board's Regulation Y (12 CFR 225.7). These exceptions include (1) situations where the tied product is a traditional bank product offered by an affiliate of the bank, (2) combined-balance discount packages, and (3) bank transactions with foreign persons.

The Board is also authorized, in consultation with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, to grant additional exceptions to the statute's prohibitions by regulation or order.

INTERNAL CONTROLS TO PROMOTE COMPLIANCE WITH PROHIBITIONS OF SECTION 106

Banks should have policies, procedures and systems in place that are reasonably designed to promote bank compliance with the tying prohibitions of section 106. The types of policies, procedures, and systems appropriate for a particular bank depend on the bank's size, and the nature, scope, and complexity of its activities. Banks should review and update their policies, procedures, and systems periodically to ensure that they reflect any changes in the nature, scope, or complexity of their activities or applicable statutes, regulations, or supervisory guidance.

Banks should also ensure that appropriate bank personnel receive education and training concerning the provisions of section 106. A bank's internal audit function should periodically review and test its tying policies, procedures, and systems in order to confirm that they are working effectively and in the manner intended.

SUPERVISORY CONSIDERATIONS

Federal Reserve examiners review and evaluate a bank's policies and procedures related to tying arrangements.[7] Depending on the facts and circumstances, it may be appropriate to assess compliance with section 106 at the holding company or the state member bank. Examiners should focus on the holding company's responsibility to oversee and safeguard against prohibited tying arrangements by its bank subsidiaries and affiliates. In addition, examiners may conduct more targeted examinations of the marketing programs, training materials, internal reports and internal tying investigations of a bank. Examiners should be aware that the principal objective of section 106 is to eliminate any potential for "arm twisting" customers into buying some other product to get the product they desire. In assessing tying arrangements, examiners should focus their review on the bank's policies, procedures, and internal controls as well as training and audit programs covering compliance with section 106.

As part of this supervisory review, examiners should consider whether tying arrangement policies and procedures have been updated to reflect changes in products and services. Effective policies may contain examples of impermissible practices relevant to the product lines and procedures for employees to follow if questions arise concerning the application of the tying prohibitions.

Examiners should assess whether bank management has established and reviewed key risk management practices to eliminate impermissible tying arrangements when offering customers multiple products or services. For instance, effective training programs raise bank staff's awareness of the prohibitions against tying arrangements. Examiners should determine whether a bank has adopted adequate training programs for employees and whether the training material is appropriately updated. Examiners also should ascertain whether bank management appropri-

7. Section 3500 of the *Bank Holding Company Supervision Manual* provides detailed examination objectives and procedures related to section 106.

ately responds to questions from bank staff about tying.

Examiners should assess the adequacy of the bank's audit and compliance programs related to tying arrangements. If the audit program focused on tying arrangements is infrequent or inadequate, examiners may consider reviewing a sample of pertinent extensions of credit (for example, loans, lines of credit, and letters of credit) that may be susceptible to improper tying arrangements. Examiners should

- review pertinent extensions of credit (for example, loans, lines of credit, and letters of credit) to borrowers whose credit facilities or services may be susceptible to tying arrangements imposed by the bank or company in violation of section 106 or the Board's regulations;
- monitor incentives that may encourage tying by bank employees, such as commission structures and fee-splitting arrangements between departments; and
- respond to any customer allegations of prohibited tying arrangements.

The determination of whether a violation of section 106 has occurred often requires a careful review of the specific facts and circumstances associated with the relevant transaction between the bank and the customer. If there is an apparent violation of law at the bank, examiners generally should communicate the findings in the report of examination or supervisory letter. Examiners should

- name the applicable law (Section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972)) or regulation (Regulation Y, 12 CFR 225.7);
- provide a brief description of the scope of the relevant law;
- describe the requirements of the regulation or statute;
- note how or why the violation occurred; and
- describe any plans or recommendations for corrective action.