



FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT

January 15, 1987

DALLAS, TEXAS 75222

Circular 87-4

TO: The Chief Executive Officer of all
member banks, bank holding companies
and others concerned in the
Eleventh Federal Reserve District

SUBJECT

**Request for public comment on Regulation Y -- Bank Holding Companies
and Change in Bank Control**

DETAILS

The Board of Governors of the Federal Reserve System has requested public comment on proposed rulemaking to its Regulation Y to permit bank holding companies to engage in real estate investment activities within certain limits. The Board also is requesting public comment regarding whether a subsidiary of a holding company bank should be permitted or prohibited from conducting real estate activities, and on whether bank holding companies should be permitted to conduct real estate investment activities on a nationwide basis.

Comments should be addressed to Mr. William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551. All correspondence should refer to Docket No. R-0537 and must be received by February 23, 1987.

ATTACHMENTS

The Board's press release and the material as published in the Federal Register are attached.

MORE INFORMATION

For further information, please contact Basil Asaro at (214) 698-4345, Gayle Teague at (214) 651-6481, or David W. Dixon of the Legal Department at (214) 651-6228.

Sincerely yours,

For additional copies of any circular please contact the Public Affairs Department at (214) 651-6289. Banks and others are encouraged to use the following incoming WATS numbers in contacting this Bank (800) 442-7140 (intrastate) and (800) 527-9200 (interstate).

FEDERAL RESERVE press release



For immediate release

December 31, 1986

The Federal Reserve Board today requested comment on proposed rulemaking to permit bank holding companies to engage in real estate investment activities within certain limits. The proposed limits are designed to ensure that conduct of the activity does not result in unsafe or unsound practices, unfair competition, conflicts of interest or other adverse effects.

Comments should be received by the Board on this matter by February 23, 1987.

The specific conditions on which the Board requests comment include:

- a requirement that the activity be conducted through a direct nonbank real estate subsidiary of the bank holding company;
- a requirement that bank holding companies that engage in these activities meet certain capital standards, and that the amount of real estate investment activities conducted directly or indirectly by the bank holding company be considered in determining the adequacy of a bank holding company's capital;
- a requirement that a bank holding company's total real estate investment activities, including related extensions of credit, not exceed the larger of 25 percent of the bank holding company's consolidated primary capital or \$250,000;
- a requirement that the bank holding company's total investment in real estate subsidiaries be limited to 5 percent of the bank holding company's consolidated primary capital;

(over)

- a limitation on the total leverage in a real estate subsidiary equal to 5 times the capital of the real estate subsidiary;
- a limitation of the total investment in a single real estate project or series of related real estate projects to 10 percent of the bank holding company's consolidated primary capital;
- a requirement that the real estate subsidiary conduct all real estate investment activities through passive, noncontrolling investments in joint ventures or partnerships, with the total investment by the real estate subsidiary representing no more than 49 percent of the equity of the joint venture or partnership; and,
- a requirement that during each of the first three years, a bank holding company may invest no more than one-third of its aggregate real estate investment limit in these activities.

The Board also requests public comment regarding whether a subsidiary of a holding company bank should be permitted or prohibited from conducting real estate investment activities, and on whether bank holding companies should be permitted to conduct real estate investment activities on a nationwide basis.

The Board's notice is attached.

Proposed Rules

Federal Register

Vol. 52, No. 4

Wednesday, January 7, 1987

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R-0537]

Bank Holding Companies and Change in Bank Control; Permissibility of Real Estate Investment Activities for Bank Holding Companies and Their Direct and Indirect Nonbank Subsidiaries

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed Rule.

SUMMARY: The Federal Reserve Board is soliciting comment as part of a rulemaking proceeding under the Bank Holding Company Act to permit bank companies to engage in real estate investment activities under specific conditions that have been designed to ensure that the conduct of the activity does not result in unsafe or unsound banking practices, unfair competition, conflicts of interest, or other adverse effects. The Board is seeking comment on whether real estate investment activities are closely related to banking for purposes of section 4(c)(8) of the Bank Holding Company Act when conducted within the framework set forth in this proposal. The Board also seeks comment on a number of specific conditions, including requirements that: (a) the activity be conducted only through a nonbank subsidiary of the bank holding company (the "real estate subsidiary"); (b) the real estate subsidiary be maintained independent in name and operation from any bank affiliate and maintain adequate capital; (c) a bank holding company desiring to engage in real estate investment activities comply with certain capital

requirements; and (d) the real estate subsidiary's investment be limited to a passive, nonvoting equity investment. In addition, the Board seeks comment on possible limitations on the level of the holding company's exposure to this activity, including limitations regarding: (a) The amount of the holding company's investment in the real estate subsidiary and on the real estate subsidiary's leverage; and, (b) the bank holding company's total investment in real estate investment activities, including equity investments and lending by the holding company and its affiliates to any project in which the real estate subsidiary has an interest, a co-venturer or other co-participant with the real estate subsidiary in a real estate project, or purchasers of property in which the real estate subsidiary has an interest.

The Board is also seeking comment on whether, in authorizing the activity for bank holding companies subject to these proposed prudential limitations, the Board should prohibit or limit the conduct of real estate investment activities through nonbank subsidiaries of banks that are owned by bank holding companies, and should establish special capital requirements for bank holding companies that control banks directly engaged in real estate investment activities to reflect the increased risk to the bank holding company system from such activities. Moreover, the Board seeks comment on the appropriate geographic scope for the conduct of these activities.

DATE: Comments must be received by February 23, 1987.

ADDRESS: All comments, which should refer to Docket No. R-0537, should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, DC 20551, or delivered to Room B-2223, 20th & Constitution Avenue NW., Washington, DC, between 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m. weekdays.

FOR FURTHER INFORMATION CONTACT: Virgil Mattingly, Deputy General Counsel (202/452-3430), Scott G. Alvarez, Senior Counsel (202/452-3583), Legal Division; Roger Cole, Manager (202/452-2618), Margaret Spillenkothen, Supervisory financial Analyst (202/452-2720), Division of Banking Supervision

and Regulation; or Myron Kwast, Chief, Financial Studies Section, Division of Research and Statistics (202/452-2909), Board of Governors of the Federal Reserve System, Washington, DC 20551. For the hearing impaired *only*, Telecommunications Service for the Deaf, Earnestine Hill or Dorothea Thompson, (202/452-3544).

SUPPLEMENTARY INFORMATION:

I. Introduction

During the past several years, a number of states have enacted legislation permitting banks chartered and operating in those states to conduct a wide range of real estate investment and development activities. The Board has held since 1972 that real estate investment and development activities are not closely related to banking and, therefore, are not permissible nonbanking activities for bank holding companies under the Bank Holding Company Act ("BHC Act").

In response to the recent initiatives by states, the Board, in January 1985, requested public comment on whether the Board should initiate rulemaking under section 4(c)(8) of the BHC Act to permit bank holding companies to conduct real estate investment activities or whether the Board should exercise its authority to prohibit bank holding companies from directly or indirectly conducting real estate investment activities. 50 FR 4519 (January 31, 1985). The FDIC is also reviewing a proposal in this area, and the Federal Home Loan Bank Board is considering whether to readopt its existing regulations, due to expire in March 1987, permitting federal thrift institutions limited authority to engage in real estate investment activities.

In its initial request for comment, the Board expressed a number of supervisory concerns regarding the risks, conflicts of interest, and other potential adverse effects associated with the real estate investment activities, and requested comment regarding whether these concerns could be addressed by establishing certain prudential limits within which bank holding companies could conduct real estate investment activities.

The general prudential limits put forward by the Board in its initial request for comment included:

- (1) A requirement that all real estate investment activities be conducted through a separate nonbank real estate subsidiary of the bank holding company;
- (2) A minimum parent bank holding company capital level;
- (3) Limitations on the maximum investment a bank holding company may make in its real estate subsidiary;

(4) Limitations on the amount of leverage in the real estate subsidiary;

(5) A requirement that the investment in real estate projects be passive, and limited in size and scope;

(6) Limitations on all lending by the bank holding company and its subsidiaries to the real estate subsidiary, any project in which it has an interest, all co-venturers or partners, and any purchasers of real estate in which the real estate subsidiary has an interest; and

(7) Limitations on transactions as fiduciary. The Board also requested comment on whether bank holding companies should be authorized to conduct real estate investment activities on a nationwide basis, or only in states that permit state banks to conduct these activities, and on whether limitations on real estate investment activities imposed by individual states on state banks should apply to bank holding companies conducting real estate investment activities within the state.

A total of 145 comments were submitted, with respondents including banks and bank holding companies, a number of bank holding company and real estate trade associations, and several state bank supervisors. The vast majority of comments—107 in total—advocated that the Board authorize bank holding companies to conduct real estate investment activities within prudential limits in order to permit bank holding companies to compete more equally with other financial institutions in the real estate lending business and to share in the rewards of real estate appreciation and development.

Twenty-nine comments urged the Board to prohibit real estate investment activities largely because of the significant risks these commenters perceived in real estate investment activities and the possibility of conflicts of interest and anticompetitive tying arrangements.

II. Possible Adverse Effects of Real Estate Investment Activities

The Board continues to believe that real estate investment activities involve a significant degree of risk beyond other activities conducted by banks and bank holding companies. Investments in real estate are often characterized by considerable variations in economic value, returns and cash flow. In addition, real estate investments are generally illiquid, particularly during periods that involve economic stress on the banking system. To the extent that the profitability of a particular real estate investment rests upon hopes for capital appreciation rather than on

established operating profits, the risks of the investment become even greater.

Moreover, while the rewards of an equity investment in a real estate project may be potentially greater than the income from an extension of credit to the same project, the risks associated with an equity investment are typically greater than those associated with a loan. An equity investor is an unsecured and subordinated investor whose entire investment is at risk until the real estate project is completed or sold. A mortgage lender typically receives payments throughout the life of the real estate project and stands to lose only the difference between the outstanding loan balance plus any unpaid interest and the liquidation value of the property.

In addition to those risks, permitting banks and bank holding companies to engage in real estate investment activities raises the potential for conflicts of interest. It has been argued that the ability of banks to make prudent credit judgments and to serve as impartial providers of credit could be subject to potential conflicts of interest if the bank or its affiliate were also a real estate investor or developer. In particular, a bank's credit judgment could be inappropriately influenced by the incentive of an equity participation in a real estate project or by the fact that an affiliate of the bank or a person related to the bank, including an officer, director or principal shareholder, has made an equity investment in the real estate project. Further, a bank could be inappropriately influenced not to lend to an independent developer of a project that would be in direct competition with one in which the bank or one of its affiliates has an equity interest.

III. Proposed Prudential Limits on Real Estate Investment Activities

In light of the risks associated with real estate investment activities and the potential for conflicts of interest that may accompany these activities, the Board proposes to establish certain prudential limits for the conduct by bank holding companies of real estate investment activities. The Board requests public comment regarding whether these limitations, individually and taken together, are adequate and appropriate for addressing any issues of safety and soundness, conflicts of interest and other adverse effects that may be associated with bank holding companies conducting real estate investment activities.

1. Definition of Real Estate Investment Activities

The attached proposal would define real estate investment activities as the direct or indirect ownership of any interest in real estate, whether in the form of an equity interest, partnership, joint venture or otherwise. The proposal would permit bank holding companies to invest—through a separate nonbank real estate subsidiary and subject to the other prudential limits discussed below—in real estate of any kind and at any stage of development, including by taking an equity position in improved or unimproved real estate as part of a financing transaction, or purchasing raw land for development.¹

The attached proposal would define real estate investment activities also to include acquisition, development and construction arrangements that have been deemed by the Notice to Practitioners from the American Institute of Certified Public Accountants to be real estate investments or real estate joint ventures.² The Board has also reserved the right to determine on an individual basis that the facts and circumstances surrounding a particular interest may require treatment of that interest as a real estate investment for purposes of this proposed regulation. The Board requests comment regarding whether other types of loans or investments should be included within the definition of real estate investment activities.

The Board also requests public comment regarding whether real estate

investment activities should also include activities that are incidental to the ownership of real property, such as property management, maintenance and brokerage activities conducted in connection with real estate in which the bank holding company has an interest. The Board does not now propose to authorize bank holding companies to engage generally in real estate brokerage, management, or maintenance activities.

The attached proposal does not contemplate that bank holding companies would be permitted directly or indirectly to conduct, or own shares of companies that conduct, real estate syndication, construction engineering, architectural design or other similar commercial activities, or provide title insurance, whether or not these activities are conducted in connection with real estate in which the bank holding company has an interest. Bank holding companies would be permitted, however, to enter into contracts with independent third parties that provide these services in connection with real estate in which the bank holding company has an interest.

2. Separate Subsidiary

Under the proposal, a bank holding company could conduct real estate investment activities only through a separately incorporated nonbank subsidiary of the bank holding company. The proposal would permit a bank holding company to invest an aggregate of up to 5 percent of its consolidated primary capital in equity of real estate subsidiaries. Each real estate subsidiary would be required to maintain a level of capital that is fully adequate to meet its obligations and could not leverage its capital more than 5 times.

The proposal would prohibit a bank holding company from conducting real estate investment activities through a nonbank subsidiary of a holding company bank. This requirement is intended to separate the bank subsidiaries of holding companies as much as possible from real estate investment activities and any adverse effect they could have on bank subsidiaries including the direct legal obligation for losses that might result from these activities.³

The Board proposes, as an alternative, that nonbank subsidiaries of holding company banks be permitted to engage in real estate investment activities—where the parent bank has been

authorized under state law to conduct these activities—within the limits and subject to the restrictions that would apply to the conduct of real estate investment activities by a direct nonbank subsidiary of a bank holding company.

As discussed below, these proposals would require the Board to amend its existing regulation permitting nonbank subsidiaries of holding company banks to conduct any activity that the parent bank is permitted under state law to conduct directly. The Board does not propose to amend this regulation otherwise. In this connection and as discussed below, the Board will consider public comment regarding the scope of the Board's authority under section 4 of the BHC Act to regulate the real estate investment activities of these nonbank subsidiaries of holding company banks.

The proposal would also require that the real estate subsidiary maintain adequate and separate books and records, and operate in a manner that makes clear to customers, co-investors, and others dealing with the real estate subsidiary that the obligations of the subsidiary are not insured by any agency of the federal government and are not obligations of any affiliated banks.

In order to maintain the separation between the banks in a holding company and real estate subsidiaries of the bank holding company, the Board also requests comment regarding whether the real estate subsidiary should be required (1) not to share a common name or identifying symbol with its bank affiliates, (2) not to maintain any officers, directors or employees in common with its bank affiliates, and (3) to operate at locations separate from its bank affiliates. The Board requests comment whether these restrictions are likely to lessen the potential for conflicts of interest that may result from combining real estate investment and bank lending activities and to enhance the ability of the bank affiliate to isolate itself from legal obligation for any losses that may be associated with the real estate investment activities of its affiliates. In this regard, the Board notes that the FDIC has proposed adopting similar restrictions to address these concerns.

The Board also requests comment regarding whether bank holding companies engaged in real estate investment activities should be required to submit, on a quarterly basis, information necessary to monitor the performance of real estate investment activities and their compliance with the

¹ The proposed regulation would not affect or limit the current regulatory provisions permitting bank holding companies and their subsidiary banks to invest in real estate for bank and bank holding company premises, to hold real estate acquired in satisfaction of a debt previously contracted, or to make community welfare investments, provided that these investments are made pursuant to, and conform with, the Board's, or other appropriate bank supervisor's regulations regarding these types of investments.

² These loans generally (1) provide all or substantially all of the funds necessary for a real estate venture with the borrower providing little or no equity to the venture, (2) include loan commitment and/or origination fees in the amount of the loan, (3) include accrued interest and/or fees during the term of the loan in the amount of the loan, (4) permit the lending bank to participate to a significant extent in expected residual profits of the project during the life of the project or upon sale of the property, (5) are secured by the real estate without recourse to the resources of the borrower, (6) are structured so that foreclosure as a result of delinquency is unlikely during the project's development because the borrower is not required to make any payments until the project is completed, and (7) effectively permit the lender to recover its funds only if the property is sold to an independent third party, the borrower obtains refinancing from another source, or the property is placed in service and generates sufficient net cash flow to service the debt. AICPA Notice to Practitioners, *The CPA Letter*, February 10, 1986.

³ Under this alternative, a bank would not be authorized to establish a subsidiary under the Bank Service Corporation Act to engage in real estate investment activities. 12 U.S.C. 1861 *et seq.*

prudential limits set forth in this proposal.

3. Limitations on Size of Real Estate Investment Activities

The attached proposal would authorize bank holding companies to engage in real estate investment activities up to an aggregate limit of the higher of 25 percent of the consolidated primary capital of the bank holding company, or \$250,000.⁴ This aggregate investment limit would apply to the total of: (1) All direct or indirect investments, in any form, in real estate by the real estate subsidiary, and (2) all loans, advances, commitments and guarantees by the bank holding company or any of its bank or nonbank subsidiaries (i) to or for the benefit of a real estate project in which the real estate subsidiary has any equity interest, (ii) to partners, co-venturers, or contractors involved in such a real estate project, or (iii) to anyone that purchases real estate in which the real estate subsidiary has an interest, except for individual purchases of owner-occupied single family housing units.⁵ This aggregate limit is intended to govern all investments, in any form, in real estate and all forms of credit or commitments to extend credit by the bank holding company or any of its bank or nonbank subsidiaries, to any party connected with real estate or a real estate project in which the real estate subsidiary has an interest. The Board requests comment regarding the appropriate level and definition of this overall limit.

As noted, in the previous section, the Board also proposes to place a limit of 5 percent of the bank holding company's primary capital on the aggregate equity investments by bank holding companies in real estate subsidiaries. Thus, a bank holding company would, under this proposal, be permitted to invest an amount equal to up to 5 percent of its primary capital in equity of any number of real estate subsidiaries. The total real estate investment activities that these real estate subsidiaries may conduct, including all related extensions of credit by the real estate subsidiary, the bank

⁴ As noted above, investments in bank premises, real estate acquired entirely as the result of a debt previously contracted, and similar real estate acquisitions currently permitted under the BHC Act would not be subject to the proposed investment limits provided the investments are made pursuant to, and conform with, the Board's, or other appropriate bank supervisor's, regulations regarding these types of investments.

⁵ In addition, the limitations of section 23A of the Federal Reserve Act would also apply to transactions, including loans and the purchase of assets, between a bank and its affiliate, including an affiliate engaged in real estate investment activities. 12 U.S.C. 371c; 12 U.S.C. 1828(j).

holding company, and any of its bank or nonbank subsidiaries, would then be limited to an aggregate total of 25 percent of the bank holding company's primary capital.

In determining whether a bank holding company has reached its 25 percent investment limit, real estate investments and related loans made directly by banks owned by the holding company would be deducted from the 25 percent level, even if the real estate affiliate has no interest in the real estate. This would prevent a holding company, for example, that had utilized its full 25 percent limit through a nonbank real estate subsidiary from making additional investments directly in a bank owned by the holding company. It would also preclude a holding company that conducts a significant amount of real estate investment activities directly in its banks under provisions of state law, which may, for example, permit the bank to devote up to 100 percent of its equity capital to direct real estate investment activities, from conducting additional real estate investment activities through a nonbank real estate subsidiary of the holding company.

It should be noted, however, that while the attached proposal would count the direct real estate investment activities of a bank owned by a holding company towards that holding company's aggregate real estate investment activity limit, the proposal would not limit in any way real estate investment activities that are conducted directly and entirely within a state bank owned by a bank holding company. Thus, the proposal would not limit a bank's direct and sole ownership of title to a plot of real estate acquired for any purpose permitted under state law, including for the purpose of independently contracting for the development of the property. A holding company bank's investment in real estate would be covered under the attached proposal, on the other hand, if the bank acquires voting shares of a company, including a partnership or joint venture, for the purpose of investing in real estate—as opposed to the bank acquiring title to the real estate directly.⁶

Within this general limit, the Board also seeks comment on whether to establish sublimits that would apply to particular types of real estate investment activities, such as investments in raw land, property under development, or property producing

insufficient income to cover operating expenses. These sublimits may be appropriate as a means of recognizing and limiting the different degrees of risk associated with different types of real estate investment activities.

The alternative ceiling of \$250,000 is proposed in order to permit small bank holding companies to participate in a meaningful way in real estate investment activities.

4. Capital Adequacy of Bank Holding Company

The proposal would require that bank holding companies seeking to engage in real estate investment activities be in satisfactory financial condition and be particularly strongly capitalized. In the event that, after the bank holding company has commenced real estate investment activities, the bank holding company's falls below the minimum level set in the Board's Capital Adequacy Guidelines or such higher level set by the Board in approving the bank holding company's entry into this activity, it is proposed that the bank holding company be permitted to complete its ongoing real estate projects, but be prohibited from initiating new real estate investment activities until its capital position is adequate.

Because of the significant risks discussed above that are associated with real estate investment activities, the Board also proposes to amend its Capital Adequacy Guidelines to provide that funds devoted to real estate investment activities be excluded on a weighted basis (for example, at a level of 50 to 100 percent) from the calculation of the parent holding company's capital for capital adequacy purposes. The Board would take this action pursuant to authority granted under the BHC Act and the International Lending Supervision Act. 12 U.S.C. 3701 *et seq.* In this regard, the Board seeks comment on the appropriate weight at which real estate investment activities should be excluded.

The Board notes that the appropriate discount to be given to real estate investment activities in calculating capital adequacy should be influenced by the level of real estate investment activities that bank holding companies are authorized to conduct. The proposal suggests that a 50 percent discount would be appropriate in the event bank holding companies are authorized to devote approximately 25 percent of their capital to real estate investment activities. The Board requests comment regarding whether the safety and soundness concerns raised by increasing the aggregate investment

⁶ See *Security Pacific Corporation*, 72 Federal Reserve Bulletin 800 (1986).

limit above 25 percent might be adequately addressed by setting a higher discount to be given these activities in calculating the adequacy of a bank holding company's capital.

5. Adjustment to Capital for Bank Holding Companies That Control Banks Engaged in Real Estate Investment Activities

In order to address the risks to the bank holding company organization as a whole from real estate investment activities conducted directly in a holding company bank, the Board proposes, pursuant to authority granted under the BHC Act and the International Lending Supervision Act, to amend its Capital Adequacy Guidelines to provide a weighted adjustment to the primary capital of bank holding companies that control banks engaged directly in real estate investment activities. This proposal is similar to the exclusion proposed and discussed above for real estate investment activities conducted through a nonbank real estate subsidiary of the bank holding company and would provide that, in calculating the consolidated primary capital of the bank holding company, a given percentage of the amount of real estate investment activities conducted directly in the bank (up to 100 percent) would be excluded.

The Board requests comment on the appropriate discount that should be given to these activities in determining the bank holding company's capital level. In particular, the Board requests comment on whether the weighted adjustment for real estate investment activities conducted directly by a bank should be set at a level that is different from the adjustment made to the capital of the bank holding company for real estate investment activities conducted through direct nonbank subsidiaries of the holding company. This difference in weighting may be appropriate in order to reflect the greater risk posed to the bank holding company organization from conducting real estate investment activities directly in a holding company bank.

6. Limit to Essentially Passive Investment

The attached proposal includes a provision that would limit a real estate subsidiary's investment in real estate to an essentially passive, noncontrolling investment in a joint venture or partnership with third parties that are independent of, unrelated to, and do not share common officers, directors, principal shareholders, or employees with the bank holding company or any of its subsidiaries or affiliates. The

provision would also limit the real estate subsidiary's investment to no more than 49 percent of the equity of the partnership or joint venture, thereby requiring that other independent investors maintain a substantial economic interest in the project.

This condition has been proposed as a method of permitting bank holding companies to participate in the financial rewards of real estate investment activities, such as real estate appreciation, while limiting the bank holding company's exposure to the risks of real estate projects. Limiting a bank holding company to a passive role may also encourage bank holding companies to seek prudent and knowledgeable co-venturers or partners who would provide the real estate project with necessary expertise and would be motivated by a substantial economic stake in the project. The Board requests public comment regarding whether this condition is appropriate. As discussed below, the Board also requests comment regarding whether this limitation may be necessary to assure that real estate investment activities of bank holding companies are closely related to banking.

As an alternative to limiting bank holding companies to passive investments, the Board requests comment on whether bank holding companies should be permitted through their real estate subsidiaries to acquire a majority interest in real estate projects and to participate actively in the management decisions of the real estate project, including decisions regarding selecting and replacing partners and contractors associated with the real estate project. The Board does not propose under either alternative to permit bank holding companies to engage in, or own shares of a company engaged in, real estate syndication, construction, engineering, architectural design or similar commercial activities.

The Board proposes under both alternatives that bank holding companies be required to conduct real estate investment activities only with third parties that are independent of, and unaffiliated with, the bank holding company or any of its subsidiaries. Under both alternatives, the bank holding company would be prohibited from conducting real estate investment activities with any project in which officers, directors, employees, or principal shareholders (including members of their immediate family) of the bank holding company or any of its bank or nonbank subsidiaries have also invested. It is proposed that this restriction would also extend to entities

that provide services, including consulting, management, design, development, construction, brokerage, or any other services, in connection with real estate in which the real estate subsidiary has an interest.

7. Single Project Limitation and Phase-In Period

The proposal would also limit the total investment, including related extensions of credit as defined above, that a bank holding company may make in a single real estate project, or series of related projects, to 10 percent of the bank holding company's consolidated primary capital. The proposal would also provide that a bank holding company may not, during the first three years in which it conducts these activities, invest more than one-third of its aggregate real estate investment activity limit in real estate investment activities in any one twelve-month period, thereby establishing a three year phase-in period for real estate investment activities.

8. Geographic Limits and State Restrictions

The Board proposes to permit bank holding companies to conduct real estate investment activities on a nationwide basis, except in those states that prohibit banks and bank holding companies operating in that state from conducting these activities. This proposal is consistent with the Board's approval of other types of nonbanking activities, and permits bank holding companies to gain the benefits of geographic diversification of their real estate investment activities. This proposal also reserves the right to the states to prohibit real estate investment activities by banks and bank holding companies, provided that the state prohibition applies equally to both in-state and out-of-state banks and bank holding companies.

9. Restrictions on Lending and on Actions as Fiduciary

The Board also proposes to require that extensions of credit to any third party for the purpose of acquiring an interest in real estate in which the real estate subsidiary has an interest, or to a real estate project, partner, co-venturer, or contractor to a project in which the real estate subsidiary has an interest must be on substantially the same terms and conditions as comparable loans where the real estate subsidiary does not have an interest. As noted above, the Board proposes that the amount of these loans would be included in the

overall investment limit described above.

The Board also proposes to require that a bank holding company not purchase or lease, in its capacity as a fiduciary, co-fiduciary or managing agent, any property in which a real estate subsidiary of the holding company has an interest or which it sells or markets, unless the purchase or lease is: (1) Expressly authorized by the account instrument or court order; (2) specifically authorized by all interested parties after full disclosure of all relevant facts surrounding the fiduciary institution's relationship with the real estate subsidiary; or (3) otherwise permissible under applicable law or regulations.

IV. Legal Framework

The Board may authorize bank holding companies to engage in real estate investment activities under section 4(c)(8) of the BHC Act only if the Board determines, by order or regulation and after notice and opportunity for hearing, that real estate investment activities are so closely related to banking or managing or controlling banks as to be a proper incident thereto. 12 U.S.C. 1843(c)(8).

In *National Courier Association v. Board of Governors*,⁷ the court suggested three standards that would aid the Board in determining whether a specific activity is closely related to banking:

- (1) Banks have generally provided the proposed service in the past;
- (2) The proposed services are operationally or functionally so similar to existing services or activities provided by banks and bank holding companies as to make banks and bank holding companies particularly well equipped to provide the proposed services; or
- (3) Existing services that banks and bank holding companies provide are so integrally related to the proposed activity as to require its provision in a specialized form.

In determining whether a particular activity is a proper incident to banking, the Board is required to consider whether performance of the activity by a bank holding company or its affiliate can reasonably be expected to produce benefits to the public that outweigh possible adverse effects.

The Board seeks public comment regarding whether the real estate investment activities described in this proposal may be authorized by the Bank Holding Company Act to permit activities that are closely related to banking and are a proper incident thereto. 12 U.S.C. 1843(c)(8).

In this regard, several of the comments received by the Board in response to its preliminary request for comment argued that real estate investment activities are closely related to banking under the first two criteria suggested in *National Courier*. Commenters argued that banks and bank holding companies have traditionally engaged in a variety of real estate investment activities in connection with the ownership, leasing and management of bank premises. Bank holding companies also conduct a full range of real estate management and development activities as the interim owner of real estate acquired through default on a debt previously contracted ("dpc"). Similarly, bank holding companies are permitted to make equity investments in corporations or projects designed primarily to promote community welfare, including through the ownership and development of housing, and may conduct other activities that are related to real estate investment activities, such as real estate leasing activities, real estate appraisal activities, and acting as intermediary for commercial real estate equity financing. 12 CFR 225.25(b) (6), (5), (13), and (14).

Commenters also argue that real estate investment activities, particularly when conducted as a means of financing commercial real estate projects, are the functional and operational equivalents of traditional long-term debt financing activities of banks. These commenters contend that the process of determining whether to invest in a real estate project requires the same type of review of the business and economic risks of the projects as must currently be done by banks in determining whether to extend credit to the real estate project. This credit review process includes reviewing the credit worthiness and financial resources of the participants; reviewing the geographic location and design of the project; analyzing the market, sales and rental prospects, and payout/payback projections for the project; reviewing alternate sources of financing; and reviewing prospects for end-use financing.

The Board requests public comment regarding whether these and other activities currently conducted by banks and bank holding companies would support a determination that real estate investment activities, when conducted within the limits proposed here, are closely related to banking for purposes of the BHC Act. In addition, the Board requests comments regarding what, if any, restrictions should be imposed on real estate investment activities in order to limit bank holding companies to conducting real estate investment

activities that are closely related to banking.

In this regard, the Board specifically requests comment regarding whether, in order to meet the closely related to banking test, real estate investment activities of bank holding companies must be limited to passive, noncontrolling, minority investments in joint ventures or limited partnerships. These types of passive investments may be structured as the functional equivalent of a loan and would limit the bank holding company's involvement in a real estate project essentially to its traditional role of an extender of credit. The Board also seeks comments regarding whether bank holding companies may be permitted under the closely related test to take a more active, entrepreneurial role in the management decisions regarding real estate projects in which the bank holding company has invested.

V. Limitations on Real Estate Investment Activities of Nonbank Subsidiaries of Holding Company Banks

As explained above, the Board requests public comment regarding whether, in light of the financial risks, potential conflicts of interest and other adverse effects potentially arising from real estate investment activities, the Board should prohibit nonbank subsidiaries of holding company banks from engaging in real estate investment activities or should permit nonbank subsidiaries of holding company banks to engage in these activities only within the limits set forth in this proposal for other nonbank subsidiaries of the holding company. Both of these proposals would involve Board action to amend § 225.22(d)(2) of Regulation Y as that regulation applies to the ownership by a holding company bank of a nonbank company engaged in real estate investment activities.

Section 225.22(d)(2) of Regulation Y (formerly § 225.4(e)) allows holding company state-chartered banks to acquire or retain *all* of the voting shares of a nonbank company so long as the nonbank company engages solely in activities in which the parent bank may engage directly, at locations at which the bank may engage in these activities. 12 CFR 225.22(d)(2). The regulation thus permits a holding company state bank to establish a wholly-owned subsidiary to engage in nonbanking activities that the state bank may conduct directly even though the activities are not otherwise permitted for bank holding companies.

The Board adopted this regulation in 1971 in order to permit holding company banks to establish nonbank subsidiaries

⁷ 516 F.2d 1229 (D.C. Cir. 1975).

and to compete on an equal footing with banks that are not in a holding company. At that time, the Board stated that it would not apply the nonbanking prohibitions of the BHC Act to nonbank subsidiaries of holding company banks unless changed circumstances indicated a need to apply the provisions in order to carry out the Act's purposes or to prevent evasions of the Act. Accordingly, the Board stated that it would review the merits of that decision from time to time:

The Board should not at this time apply the [nonbanking] restrictions [of the BHC Act] to subsidiaries of banks. This decision is believed warranted by considerations of equity between banks that are and are not members of bank holding companies and by the absence of evidence that acquisitions by holding company banks are resulting in evasions of the purposes of the Act. The merits of this decision will be reviewed by the Board from time to time in light of its experience in administering the Act. (36 FR 9292 (May 22, 1986))

The developments discussed above regarding broad state authorizations for real estate investment activities suggest that reconsideration of the Board's 1971 regulation may be appropriate, insofar as it permits holding company state banks to establish subsidiaries engaged in real estate investment activities beyond the prudential limits proposed by the Board for the parent bank holding company.

In this regard, some of the comments responding to the Board's initial request for comment regarding real estate investment activities argued that the Board has no authority under the BHC Act to regulate the activities of holding company banks and their wholly-owned subsidiaries. These commenters contend that the nonbanking provisions of section 4 of the Act, by their express terms, do not apply to a bank owned by a holding company. On this basis, these commenters argue that a subsidiary of a holding company bank is also exempt from the nonbanking provisions of the Act.

Other commenters argue that the express terms of section 4 of the Act apply to voting shares acquired or retained by a bank holding company indirectly through a holding company bank as well as to shares acquired directly by the holding company. In addition, these commenters state that, under the express terms of the Act, a bank holding company may not control any subsidiary other than a bank or a nonbank subsidiary engaged in activities that have been determined by the Board to be closely related to banking or that are subject to some other exemption under the Act. These

commenters note that, under section 2(g)(1) of the Act, shares owned by any subsidiary of a bank holding company are deemed to be indirectly owned by the parent bank holding company and that any company controlled by a subsidiary bank of a bank holding company is an indirect subsidiary of the holding company.⁸ In support of these arguments, it has been noted that nonbank subsidiaries of a holding company bank are not "banks" as that term is defined in the Act, that the Act contains certain exemptions for shares held by holding company banks, which would be unnecessary if the nonbanking prohibitions of the Act did not apply to shares held by a holding company bank,⁹ and that long-standing Board interpretations of the Act state that voting stock held by a holding company bank is indirectly owned by the parent bank holding company.¹⁰ It has also been argued that the legislative history of the Act supports this view.¹¹

The Board will consider any further comments regarding this issue.

VI. Regulatory Flexibility Act Analysis

This proposal to expand the permissible nonbanking activities of bank holding companies is not expected to have a significant economic impact on a substantial number of small business entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). The Board is required by section 4(c)(8) of the BHC Act, 12 U.S.C. 1843(c)(8), to determine whether nonbanking activities are closely related to banking and thus are permissible for bank holding companies. This proposal, if adopted, would permit bank holding companies to engage in limited real estate investment activities that bank holding companies are not now permitted to conduct. The proposal does not impose more burdensome requirements on bank holding companies than are currently

applicable, and includes provisions designed to permit small bank holding companies to participate meaningfully in the proposed activities.

The Board believes that there are not a significant number of small bank holding companies engaged in real estate investment activities at this time. As noted, bank holding companies have not previously been permitted to engage in real estate banks to engage in these activities has been considered in a number of states, these initiatives have been taken only recently. Moreover, the proposal, if adopted, would expand the powers of bank holding companies by authorizing bank holding companies to conduct real estate investment activities within prudential limits, either by establishing a direct nonbank subsidiary of the holding company, or, under one alternative, by conducting these activities through nonbank subsidiaries of holding company banks. The proposal does not impose any limitations on the direct real estate investment activities of holding company banks or on any other activity of a holding company or its bank or nonbank subsidiaries.

The proposal requests comment regarding whether additional reporting requirements applicable to all bank holding companies that engage in the proposed activities would be appropriate.

List of Subjects in 12 CFR Part 225

Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements.

For the reasons set out in this notice, and pursuant to the Board's authority under section 5(b) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1844(b)), the Board proposes to amend 12 CFR Part 225 as follows:

1. The authority citation for Part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1843(c)(8), 1844(b), 3106, 3108, 3907 and 3909.

§ 225.25 [Amended]

2. The Board proposes to amend § 225.25 by adding a new paragraph (b)(25) to read as follows:

• • • • •
(b) • • •
(25) *Real Estate Investment Activities.* Conducting real estate investment activities, subject to the conditions and limitations set forth below. For purposes of this paragraph, real estate investment activities are defined as the direct or indirect ownership of any interest in

⁸ 12 U.S.C. 1841(g)(1).

⁹ See Bank Holding Company Act of 1956, Pub. L. No. 511, 4(c) (2) and (4), 70 Stat. 133, 136 (1956) (providing an exemption for voting shares held by "any banking subsidiary . . . in satisfaction of a debt previously contracted in good faith," and by "any banking subsidiary . . . in good faith in a fiduciary capacity") (Current version at 12 U.S.C. 1843(c) (2) & (4) (1980)).

¹⁰ 12 CFR 225.101 & 102 (1956-57); see also Board statement made in connection with promulgation of § 225.22(d)(2) (formerly 225.4(e)) of Regulation Y, 36 FR 9292 (May 22, 1971).

¹¹ See, e.g., *One Bank Holding Company Legislation of 1970*, Hearings Before the Senate Committee on Banking and Currency, 91st Cong., 2d Sess. 198 (1970), (Statement of William B. Camp, U.S. Comptroller of the Currency) ("There is no legal doubt that any acquisition by the national bank subsidiary would be an indirect acquisition by the one-bank holding company.").

real estate,¹² whether in the form of an equity interest, partnership, joint venture or otherwise, including loans and profit participations deemed for accounting purposes to be an investment in real estate,¹³ as well as incidental activities such as property management, maintenance, and brokerage of such real property.¹⁴ Real estate investment activities may be conducted by a bank holding company provided that:

(i) The activity is conducted through a separately incorporated nonbank subsidiary of the bank holding company (the "real estate subsidiary");

(ii) The bank holding company and its bank subsidiaries are in satisfactory financial condition and the bank holding company is particularly strongly capitalized on a consolidated basis. In determining a bank holding company's consolidated capital, ____ (between 50 and 100) percent of the amount of real estate investment activities, including all related extensions of credit as defined in paragraph (b)(25)(vi) of this section, conducted by all nonbank subsidiaries of the bank holding company, and ____ (up to 100) percent of the amount of real estate investment activities, including all related extensions of credit as defined in paragraph (b)(25)(vi) of this section conducted directly by a bank owned by the holding company, shall be excluded. In the event the bank holding company's consolidated primary capital falls below the minimum level set forth in the Board's Capital Adequacy Guidelines (Appendix A of this Subpart), or such higher level required by the Board in approving an application under this paragraph or under its authority under the International Lending Supervision Act, the bank holding company shall not make any further investment in the real

estate subsidiary and the real estate subsidiary shall not commence any additional real estate investment activities without the Board's prior approval;

(iii) The bank holding company's aggregated equity investments in all real estate subsidiaries shall not exceed 5 percent of the primary capital of the bank holding company;

(iv) The real estate subsidiary shall maintain capitalization fully adequate to meet its obligations and support its activities, and shall not incur debt in excess of 5 times the capital of the real estate subsidiary;

(v) The real estate subsidiary shall maintain adequate and separate books and records and shall operate in a manner so as to make clear to customers, co-investors, and others dealing with the real estate subsidiary that the obligations of the subsidiary are not insured by any agency of the federal government and are not obligations of any bank affiliated with the subsidiary;

(vi) The aggregate investment by a bank holding company in real estate investment activities, including all related extensions of credit, shall be limited to the higher of 25 percent of the bank holding company's consolidated primary capital or \$250,000, minus the aggregate investment in real estate investment activities, including all related extensions of credit, is defined as the total of (A) all direct and indirect investments in any form in real estate, (B) all loans, advances, commitments, and guarantees by the bank holding company or any of its bank or nonbank subsidiaries to any project, partner, co-venturer, contractor or other party with which the real estate subsidiary is associated in any manner regarding real estate in which the real estate subsidiary has a direct or indirect interest, and (C) all loans, advances, commitments and guarantees by the bank holding company or any of its bank or nonbank subsidiaries to any third party for the purpose of acquiring any interest in real estate in which the real estate subsidiary has a direct or indirect interest, except for mortgages made to individual purchasers of owner-occupied single family housing units;¹⁵

¹⁵ This limit does not apply to investments in bank premises, real estate acquired and held in good faith in satisfaction of debts previously contracted, and real estate acquired as part of a community welfare project of the type permitted under § 225.22(b)(8) of this subpart, provided these

(vii) During the first three years after obtaining Board approval under this subpart to conduct real estate investment activities, no more than one-third of a bank holding company's aggregate investment limits described in (b)(25)(vi) of this section shall be made during any one twelve-month period;

(viii) The aggregate investment, including any related extensions of credit, as defined in (b)(25)(vi) of this section, by a bank holding company in any single real estate project or series of related projects shall not exceed 10 percent of the bank holding company's consolidated primary capital;

(ix) The real estate subsidiary shall conduct all real estate investment activities through passive, noncontrolling investments in joint ventures or partnerships (A) with third parties that are independent of, and unrelated to, the bank holding company or its subsidiaries and affiliates, and that do not share common officers, directors, employees or principal shareholders (including members of their immediate families) with the bank holding company or any of its subsidiaries or affiliates, and (B) in which the total investment by the real estate subsidiary represents no more than 49 percent of the equity of the joint venture or partnership;

(x) The real estate investment activities may be conducted on a nationwide basis, except in a state that prohibits banks and bank holding companies operating in that state from conducting these activities;

(xi) A bank holding company that operates a real estate subsidiary authorized pursuant to this paragraph, and any subsidiary of such bank holding company, shall not extend credit to any third party for the purpose of acquiring any interest in any real estate in which such real estate subsidiary has a direct or indirect interest, unless the extension of credit is consistent with safe and sound banking practices, is made on substantially the same terms, including those governing interest rate and collateral, as those prevailing at the time for comparable transactions with other persons, and does not involve more than the normal risk of repayment or present other unfavorable features;

(xii) A bank holding company that controls a real estate subsidiary authorized pursuant to this paragraph, and any subsidiary of such bank holding company, shall not extend credit to any partner, co-venturer or other entity with

investments are made pursuant to and conform with the Board's or other appropriate bank supervisor's regulations regarding these investments.

¹² Real estate includes real property and any improvements to real property. Real estate investment activities do not include the ownership of real property acquired in satisfaction of a debt previously contracted, held for bank or bank holding company premises, or made as a community welfare investment, provided that these investments are made pursuant to, and conform with, the Board's or other appropriate bank supervisor's regulations regarding these types of investments.

¹³ In this regard, real estate investments would include acquisition, development and construction arrangements by financial institutions that have been deemed to be real estate investment or real estate joint ventures under the Notice to Practitioners by the American Institute of Certified Public Accountants (January 28, 1986). The Board may also determine in individual cases that the facts and circumstances of a particular interest warrant treatment of the interest as an investment in real estate for purposes of this subparagraph.

¹⁴ Real estate investment activities do not include directly or indirectly engaging in, or owning or controlling a company engaged in, real estate syndication, construction, engineering, architectural design, or other similar commercial activities.

which the real estate subsidiary is associated by joint venture, contract or otherwise in connection with real estate in which such real estate subsidiary has a direct or indirect interest, unless the extension of credit is consistent with safe and sound banking practices, is made on substantially the same terms, including those governing interest rate and collateral, as those prevailing at the time for comparable transactions with other persons, and does not involve more than the normal risk of repayment or present other unfavorable features; and

(xiii) A bank holding company and any of its subsidiaries shall not purchase or lease, as fiduciary, co-fiduciary, or managing agent on behalf of an account for which the holding company or subsidiary has investment discretion, any property or interest in property in which a real estate subsidiary of the holding company has an interest or which it sells or markets, unless the purchase or lease is: (A) Expressly authorized by the account instrument or court order; (B) specifically authorized by all interested parties after full disclosure of all relevant facts surrounding the fiduciary institution's relationship with the property or interest in property; or (C) otherwise permissible under applicable law or regulations.

3. The Board proposes to amend § 225.22(d)(2) by adding the following at the end of that section:

§ 225.22 [Amended]

* * * * *
(d) * * *
(2) * * *

Notwithstanding the above, a state bank owned by a bank holding company may not directly or indirectly acquire or retain securities of a company engaged in real estate investment activities as defined in § 225.25(b)(25).

* * * * *

Appendix A—[Amended]

4. The Board proposes to amend Appendix A to 12 CFR Part 225 by adding the following at the end of the Appendix:

Treatment of Investments in Real Estate Investment Activities for the Purpose of Determining the Capital Adequacy of Bank Holding Companies

In its proposal to authorize bank holding companies to engage in real estate investment activities, the Board expressed its concern that these activities involved a significant degree of risk beyond other activities conducted by banks and bank holding companies in part because of the illiquid nature of real estate; the considerable variation in economic value, returns and cash flow that often characterize investments in

real estate; and the greater risks associated with an equity investment as compared to a traditional bank loan. Based on these supervisory concerns, the Board has imposed prudential limits on the size and conduct of real estate investment activities of bank holding companies.

In addition, the Board believes that the amount of real estate investment activities conducted by a bank holding company and any of its direct or indirect bank and nonbank subsidiaries must be considered in evaluating the capital adequacy of the bank holding company. In this regard, in determining the capital adequacy of a bank holding company, ____ (between 50 and 100) percent of the amount of the real estate investment activities conducted by nonbank subsidiaries of the bank holding company, including related extensions of credit by the parent bank holding company or any bank or nonbank subsidiaries, shall be excluded from the calculation of the parent bank holding company's consolidated primary capital. Similarly, ____ (up to 100) percent of the amount of the real estate investment activities conducted directly by a bank owned by a bank holding company, including related extensions of credit by the bank holding company or any bank or nonbank subsidiary, shall be excluded from the calculation of the parent bank holding company's consolidated primary capital. For purposes of these calculations, real estate investment activities, including related extensions of credit, shall be defined as in § 225.25(b)(25) of this part.⁷ Real estate investment activities and related extensions of credit shall be deemed to be made by a bank owned by a bank holding company for purposes of applying these weighted capital adjustments if the holding company bank holds any interest, in any form, in the real estate.

Board of Governors of the Federal Reserve System, December 31, 1986.

James McAfee,

Associate Secretary of the Board.

[FR Doc. 87-183 Filed 1-6-87; 8:45 am]

BILLING CODE 6210-01-M