FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT
AND CHIEF OPERATING OFFICER

DALLAS, TEXAS 75222

November 19, 1987

Circular 87-81

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

SUBJECT

Request for public comment on Regulations H (Membership of State Banking Institutions in the Federal Reserve System) and Y (Bank Holding Companies and Change in Bank Control)

DETAILS

The Board of Governors of the Federal Reserve System has requested public comment on proposals affecting real estate investment and development activities in a holding company framework.

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-0616 and must be received by December 4, 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 Dean A. Pankonien of this Bank's Legal Department at (214) 651-6228.

Sincerely yours,

William H. Wallace

FEDERAL RESERVE press release

For immediate release November 2, 1987

The Federal Reserve Board today requested comment on proposals affecting real estate investment and development activities in a holding company framework.

Comment is requested by December 4 on whether the Board, in evaluating bank holding company proposals, should prohibit banks and savings banks in a holding company from engaging in real estate and development activities and whether these activities should be confined to nonbank subsidiaries of bank holding companies.

The Board also requests comment on whether (1) member banks, not in a holding company system, should be subject to interaffiliate lending restrictions and (2) it should impose special capital requirements on real estate subsidiaries of holding company banks.

In an earlier proposal issued in December 1986, the Board sought comment on proposed rulemaking under the Bank Holding Company Act that would permit bank holding companies to engage in real estate investment activities under specific conditions that were designed to ensure that the conduct of the activity did not result in unsafe or unsound banking practices, unfair competition, conflicts of interest, or other adverse effects.

The Board's notice on today's proposal is attached.

-0-

Attachment

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulation Y; Regulation H; Docket R-0616]

Regulations Regarding Real Estate Investment and Development Activities of Subsidiaries of Holding Company Banks

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Solicitation of public comments.

SUMMARY: The Federal Reserve Board is soliciting comment regarding whether the financial risks to a bank holding company system associated with real estate investment and development activities conducted by subsidiary banks are such that the Board, in acting on applications under the Bank Holding Company Act by bank holding companies to acquire banks or FDIC insured savings banks, should require as a condition of a favorable finding regarding the financial resources and future prospects of the banks involved, that the banks not engage in such activities directly or through a subsidiary. The Board also requests comment on whether nonbank subsidiaries of banks engaged in real estate investment and development activities, as well as real estate projects in which the subsidiary invests, and under certain circumstances, partners or co-venturers with such subsidiaries, should be considered "affiliates" of the bank for purposes of the restrictions on transactions between a bank and its affiliates contained in sections 23A and 23B of the Federal Reserve Act. 12 U.S.C. 371c and 371c-1. Finally, the Board requests comment regarding whether it should establish special capital requirements for real estate subsidiaries of holding company banks pursuant to the International Lending Supervision Act of 1982.

DATE: Comments must be received by December 4, 1987.

ADDRESSES: All comments, which should refer to Docket No. R-0616, 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: J. Virgil Mattingly, Deputy General Counsel (202/452-3430), Scott G. Alvarez, Senior Counsel (202/452-3583), Legal Division; Roger Cole, Manager (202/452-2618), 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

The Board currently has under consideration a proposal under section 4(c)(8) of the Bank Holding Company Act ("BHC Act") that would authorize bank holding companies and their nonbank subsidiaries, including nonbank subsidiaries of holding company banks where permitted under state law, to engage in real estate investment and development activities within certain prudential limits. (52 FR 543 (1987)). Alternatively, the Board has asked for comment on a proposal to continue to prohibit such activities for bank holding companies and to modify its existing regulations (12 CFR 225.22(d)(2)) so that this prohibition would apply also to nonbank subsidiaries of holding company banks.

As the Board has previously stated, the Board is concerned that real estate investment and development activities involve a significant degree of risk beyond the risks of 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.

In light of these significant risks associated with real estate investment and development activities, the Board has proposed a framework of prudential limitations for the conduct by bank holding companies of real estate activities. The Board is evaluating the public comments received regarding the appropriateness of those limits.

Several of the prudential limits outlined by the Board in its real estate proposal are designed to insulate banks owned by holding companies from the risks associated with real estate investment and development activities conducted by affiliates of the bank. In its proposal, the Board questioned whether a bank may be adequately insulated from the risks associated with such activities conducted by nonbank subsidiaries of the bank, particularly where those nonbank subsidiaries operate with management and employees of the bank. In light of the Board's concerns that it may not be feasible to insulate a bank from the risks associated with real estate investment and development activities conducted through nonbank subsidiaries of the bank, the Board requested comment in its real estate proposal regarding whether the Board should modify its existing regulation (12 CFR 225.22(d)(2)) to prohibit nonbank subsidiaries of holding company banks from conducting real estate investment and development activities and should require that all real estate investment and development activities, if permitted, be conducted only through a nonbank subsidiary held by the bank holding company and not by a subsidiary of a bank. Under the Board's existing regulation, a nonbank subsidiary of a state bank owned by a bank holding company may, without the Board's approval under the Act, conduct any activity that the state bank may conduct directly subject to the limits

imposed by state law on the bank. 12 CFR 225.22(d)(2).

The Board's current proposal under section 4 of the BHC Act does not affect real estate activities conducted directly by banks owned by holding companies. The Board has, however, asked for comment on a proposal to establish special capital requirements for bank holding companies that control such banks to reflect the increased risk to the bank holding company system from such activities.

II. Savings Banks Under the Competitive Equality Banking Act

Recently, the Board has considered a number of applications to form bank holding companies under section 3 of the BHC Act that involve banks and savings banks permitted under state law to engage directly and through subsidiaries in various real estate investment and development activities. In these cases, the Applicants have agreed to limit the real estate activities of the banks and their nonbank subsidiaries, to comply with special, enhanced capital requirements, and to conform their activities to the results of the Board's proposed rulemaking. In these cases, the Board has also taken into account the type and amount of real estate exposure of the bank or subsidiary of the bank engaged in real estate investment and development activities in evaluating the financial factors the Board is required to consider under section 3 of the BHC Act.

The Competitive Equality Banking Act of 1987 ("CEBA") recently enacted by Congress contains certain provisions regarding the nonbanking activities of savings banks. Pub. L. 100–86, 101 Stat. 552. In particular, section 101(d) provides that "a qualified savings bank" that becomes a subsidiary of a savings bank holding company (defined as a bank holding company 70 percent or more of the assets of which are represented by savings banks) may continue to engage in any activity, either directly or through a subsidiary of the savings bank, that the savings bank is permitted under state law to conduct as a state savings bank. 101 Stat. at 561–562 (to be codified at 12 U.S.C. 1842(f)).

The provisions of CEBA do not, however, affect the Board's existing authority, in connection with its analysis of an application under section 3 of the BHC Act, to evaluate the financial and managerial resources and future prospects of the bank holding company and bank involved. In this regard, the Board notes that the Senate Report on CEBA states that, while section 101(d) was intended to allow qualified savings banks to engage in state authorized activities, "[t]he Board would, however, be authorized under its general supervisory authority over bank holding companies and their subsidiaries to prevent unsafe or unsound activities; or to require the bank holding company to maintain higher levels of capital to support such activities." S. Rep. No. 100–19, 100th Cong., 1st Sess. 36 (1987).

Accordingly, the Board requests comment regarding whether, and under what circumstances, the Board should, in acting on applications by bank holding companies to acquire banks or savings banks under section 3 of the BHC Act, limit real estate investment and development activities of holding company banks and their nonbank subsidiaries as a matter of safe and sound banking practice. For example, the Board requests comment on whether to require, as a condition of a favorable finding regarding the financial resources and future prospects of the banks involved in an application under section 3 of the BHC Act, that the real estate development activities be conducted through a nonbank subsidiary of the bank holding company rather than through a subsidiary of the bank or savings bank. The Board seeks comment on whether this requirement would enhance the safety and soundness of the bank holding company organization by insulating the bank more effectively from the risks associated with real estate investment and development activities.

As noted, the Board has asked for comment on whether to establish special capital requirements for bank holding companies that control banks engaged in real estate investment and development activities. The Board seeks comment on whether the Board should provide that a bank holding company not make any additional real estate investments through its bank subsidiary in the event the bank holding company's capital falls below the minimum level set forth in the Board's Capital Adequacy Guidelines or, as discussed below, such special capital levels required by the Board under the International Lending Supervision Act ("ILSA").

III. Sections 23A and 23B of the Federal Reserve Act

The Board also seeks comment regarding whether, in the event the Board decides not to limit the conduct of real estate development activities through nonbank subsidiaries of holding company banks or savings banks, the Board should apply the restrictions of sections 23A and 23B of the Federal Reserve Act to transactions between banks, including savings banks, and such subsidiaries. The Board also requests comment on whether these restrictions should be applied to banks that are not in a holding company system and thus would not be subject to any rules the Board may adopt pursuant to the Bank Holding Company Act to limit the conduct of real estate development activities by nonbank subsidiaries of holding company banks.

In this regard, the Board seeks comment on whether a nonbank subsidiary of a bank that engages in real estate activities as well as real estate projects in which these subsidiaries invest, should be deemed "affiliates" of the bank for purposes of sections 23A and 23B of the Federal Reserve Act. (12 U.S.C. 371c and 371c–1). Section 23A of the Federal Reserve Act provides that the term "affiliate" in that section includes any company that the Board determines by regulation or order to have a relationship with a bank such that transactions between the bank and that company may be affected by the relationship to the detriment of the bank. 12 U.S.C. 371c(b)(1)(E). In the event the Board determines that such a subsidiary is an "affiliate" of the bank for purposes of sections 23A and 23B, covered transactions between the bank and the subsidiary would be limited to 10 percent of the bank's capital and such transactions would be required to be on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank, as those prevailing at the time for comparable transactions with or involving nonaffiliated companies. A covered transaction includes an extension of credit by the bank to or for the benefit of an affiliate as well as the purchase by a bank of assets from or for the benefit of an affiliate. 12 U.S.C. 371c(b)(7).

The Board is aware that banks that own real estate investment subsidiaries routinely make extensions of credit to real estate subsidiaries and to projects owned by these real estate subsidiaries of the bank. These transactions would be "covered transactions" for purposes of sections 23A and 23B if the real estate subsidiary and project were deemed to be "affiliates" of the bank. The terms or availability of credit from the bank to these real estate subsidiaries and projects may be directly and substantially affected by the relationship of the real estate subsidiary with the bank to the detriment of the bank. Consequently, the Board is considering whether these subsidiaries and the real estate projects in which they invest should be deemed

"affiliates" of the bank for purposes of sections 23A and 23B.

The Board notes that prior regulatory experience in evaluating the relationship between banks and real estate investment trusts in the 1970s and real estate investments made by thrifts suggests that the ownership of an equity interest in a real estate project often provides a powerful incentive to depository institutions to provide credit to support their real estate projects, particularly at times when credit is not available to the project from other sources due to financial or other difficulties experienced by the project. In this situation, the existence of an equity relationship between the bank or thrift could affect the terms and availability of covered transactions between the bank or thrift and the real estate project to the detriment of the depository institution.

The Board also seeks comment on whether partners, joint venturers and other companies associated with a bank or its real estate subsidiary in a real estate project should be deemed to be affiliates of the bank if these business associates use the proceeds of transactions with the bank to finance a real estate project or the company's participation in a real estate project in which the bank has an equity interest. Under this proposal, these business associates in the bank's real estate activities would not be deemed an affiliate of the bank where transactions with these business associates are limited to transactions that the bank adequately documents are on an arms-length basis and are for a purpose other than use in a real estate project in which the bank has an equity interest.

Transactions with companies associated with the bank in a real estate project may be made in order to support a partner or contractor that is experiencing financial or other difficulties that may jeopardize the completion of a real estate project in which the bank has an equity interest. These transactions may involve terms that are more favorable than otherwise available and may be made when credit is not available to the partner or contractor from another source. These transactions could, under these circumstances, be substantially affected by the bank's relationship with the partner or contractor in the real estate project to the detriment of the bank.

Moreover, one of the primary incentives to the bank in entering into a financing or similar transaction with a partner or contractor associated with the bank in a real estate project may be to benefit the real estate project. Section (a)(2) of section 23A deems any transaction by a member bank with any person to be a "covered transaction" for purposes of section 23A to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate of the bank. 12 U.S.C. 371c(a)(2). The Board requests comments on whether, and under what circumstances, these transactions should be subject to the terms of sections 23A and 23B of the Federal Reserve Act in order to protect the integrity of the bank and its credit decisions.

In addition, the Board seeks comment on whether to exclude "covered transactions" between a bank and any real estate subsidiary of the bank and partners, joint venturers or other companies associated with the real estate subsidiary in a real estate project from the provisions of § 250.250 of the Board's regulations. (12 CFR 250.250).

The Board also requests comment on the appropriate period of time to allow banks to conform existing covered transactions with their subsidiaries and real estate partners to sections 23A and 23B, in the event the Board adopts the proposals discussed above.

The Board notes that its determination with respect to member banks under sections 23A and 23B would apply to subsidiaries of nonmember banks by virtue of the provisions of the Federal Deposit Insurance Act. 12 U.S.C. 1828(j)(1).

IV. International Lending Supervision Act

The Board has already requested comment, in connection with its current real estate investment rulemaking under section 4(c)(8) of the BHC Act, on a proposal that would exclude real estate investments as well as related extensions of credit from the calculation of the bank holding company's capital for purposes of applying the Board's Capital Adequacy Guidelines. This would apply to real estate investments made by a real estate subsidiary of the bank holding company or directly by a bank or its subsidiaries, whether the activities are funded from capital provided by the bank holding company or from borrowings by the real estate subsidiaries. The Board has previously asked for comment on whether an adjustment to the bank holding company's capital based on the amount of real estate investment and development activities conducted by subsidiaries of a bank holding company is appropriate in order to address the added risks to the holding company organization from those real estate investment and development activities.

The Board now requests comment regarding whether, in order to address the risks associated with real estate activities conducted in a subsidiary of a holding company bank, the Board should, under the International Lending Supervision Act, impose a specific capital requirement directly on nonbank subsidiaries of holding company banks engaged in real estate investment and development activities. The Board also seeks comment on whether it should impose a specific capital requirement on subsidiaries of holding company banks as an alternative to the proposal discussed above to condition Board approval under section 3 of the BHC Act on termination of real estate activities by subsidiaries of banks that are subsequently acquired by bank holding companies.

In this regard, the International Lending Supervision Act provides that the appropriate federal banking agency may impose specific capital requirements on any affiliate of an insured bank, where the federal banking agency is the appropriate federal banking agency for that affiliate. 12 U.S.C. 3909(a)(2). The International Lending Supervision Act provides that the Board is the appropriate federal banking agency for bank holding companies and all nonbank subsidiaries of the holding company. 12 U.S.C. 3902. The Board solicits public comment on the appropriate levels of capital that such subsidiaries should maintain, consistent with industry norms and the safety and soundness of its affiliate banks. The Board also requests comment on whether the leverage and capital requirements proposed in its December, 1986 real estate development proposal should be applied to these subsidiaries. 52 FR 543, 546–547 (January 7, 1987).

V. Comment Period

The Board has proposed a 30-day comment period on these matters because the issues raised here supplement matters on which the Board has already received extensive public comment in connection with its rulemaking proceeding regarding real estate investment and development activities of bank holding companies. The Board expects that it will be able to act on its real estate rulemaking and the matters raised in this request for comment promptly after the close of the comment period on the matters raised in this notice.

VI. Regulatory Flexibility Act Analysis

This proposal 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 believes that there are not a significant number of small bank holding companies engaged in real estate investment and development activities at this time. As noted, bank holding companies have not previously been permitted to engage in real estate investment and development activities and, while legislation to permit state banks to engage in these activities has been considered in a number of states, these initiatives have been taken only recently. The Board will consider any comment regarding whether, and to what extent, the proposals outlined in this notice would have an impact on small business entities within the meaning of the Regulatory Flexibility Act.

List of Subjects in 12 CFR Parts 208 and 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)), and section 371c(e) of the Federal Reserve Act (12 U.S.C. 371c(e)), the Board proposes to amend 12 CFR Part 225 and 12 CFR Part 208 as follows:

PART 225—[AMENDED]

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.

2. The Board proposes to amend § 225.13(b)(1) by adding the following at the end of that section:

§ 225.13 Factors considered in acting on bank applications.

* * * * *

(6) * * *

(1) * * * In light of the risks associated with real estate investment and development activities, the Board will, in acting on any application by a bank holding company under section 3 of the BHC Act, require, as a condition of its finding that the banks involved have satisfactory financial resources and future prospects, that real estate investment and development activities not be conducted by any of such banks directly or through a subsidiary, and that such activities be conducted only in a nonbank subsidiary of the bank holding company in accordance with the prudential limitations set forth in § 225.25(b)(25) of this subpart.

* * * * *

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

Appendix A—Capital Adequacy Guidelines for Bank Holding Companies and State Member Banks

* * * * *

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

The Board believes that real estate investment and development activities involve a significant degree of risk beyond other activities conducted by banks and bank holding companies. These risks result from 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 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, the Board believes that a nonbank subsidiary of a holding company bank that is engaged in real estate investment and development activities must be adequately capitalized in order to lessen the risk to the bank holding company organization from the risks of the subsidiary's real estate investment and development activities. The Board believes that a real estate subsidiary of a holding company bank should meet the same capital and leverage requirements that the Board has proposed for direct nonbank subsidiaries of a bank holding company that engage in real estate investment and development activities. For purposes of these calculations, real estate investment activities, including related extensions of credit, shall be defined as in section 25(b)(25) of this part.

PART 208—[AMENDED]

4. The authority citation for Part 208 is revised to read as follows:

Authority: 12 U.S.C. 248, 321–338, 371c, 371c–1, 486, 1814, 3907, 3909, unless otherwise noted.

5. The Board proposes to amend Part 208 by adding a new § 208.15 under the undesignated center heading "Regulations" to read as follows:

§ 208.15 Affiliates under section 23A and B (12 U.S.C. 371c and 371c–1).

(a) For purposes of sections 23A and 23B of the Federal Reserve Act, an affiliate of a member bank includes a company that is:

(1) A subsidiary of such member bank if the subsidiary engages directly or indirectly in real estate investment or development activities as defined in § 225.25(b)(25) of Regulation Y (12 CFR 225.25(b)(25)); and

(2) A partner, joint-venturer or other company otherwise associated in a business relationship with such subsidiary in a real estate investment or development activity as described in § 225.25(b)(25) of Regulation Y, to the extent that the proceeds of any covered transaction between the member bank or its subsidiaries with the partner, joint-venturer or other company are used to finance such real estate investment or development project or the company's participation in such project.

(b) The exemptions provided in the Board's interpretation at § 250.250 of this chapter shall not apply to covered transactions between a member bank and an affiliate defined in paragraph (a) of this section.

(c) A member bank and its subsidiaries shall have six months from the effective date of this section to conform covered transactions between it and a company that becomes an affiliate as a result of this regulation to the requirements of sections 23A and 23B of the Federal Reserve Act.

(d) The terms "subsidiary", "bank", "company", and "covered transaction" used in this section shall have the meanings given in section 23A of the Federal Reserve Act. 12 U.S.C. 371c(b).

Board of Governors of the Federal Reserve System, October 30, 1987.

William W. Wiles,

Secretary of the Board.

[FR Doc. 87–25576 Filed 11–3–87; 8:45 am]

BILLING CODE 6210–01–M