TO: The Chief Executive Officer of each financial institution and others concerned in the Eleventh Federal Reserve District

SUBJECT

Transactions Between Banks and Their Affiliates (Proposed Rule); Applicability of Sections 23A to the Purchase of Securities From Certain Affiliates and to Loans and Extensions of Credit Made by a Member Bank to a Third Party (Final Rules); and Application of Sections 23A and 23B to Derivative Transactions With Affiliates and Intraday Extensions of Credit to Affiliates (Interim Rules)

DETAILS

The Board of Governors of the Federal Reserve System has proposed a new rule (Regulation W) to implement comprehensively sections 23A and 23B of the Federal Reserve Act. The proposed rule would combine statutory restrictions on transactions between a bank and its affiliates with numerous existing and proposed Board interpretations and exemptions to simplify compliance with sections 23A and 23B.

The Board must receive comments on the proposed rule by August 15, 2001. Please address comments to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551. Also, you may mail comments electronically to regs.comments@federalreserve.gov. All comments should refer to Docket No. R-1103.

Section 23A restricts the ability of a member bank to fund its affiliates through asset purchases, loans, or certain other transactions (covered transactions). The Board has adopted an interpretation that expands the types of asset purchases eligible for the exemption in section
23A(d)(6), which exempts the purchase from an affiliate of an asset that has a readily identifiable and publicly available market quotation. This interpretation, which becomes effective June 11, 2001, expands the ability of an insured depository institution to purchase securities from its registered broker-dealer affiliates while ensuring that the transactions are conducted in a manner consistent with safe and sound banking practices.

Section 23A also restricts the ability of a member bank to fund its affiliates through investments, loans, asset acquisitions, or certain other transactions (covered transactions). Section 23A deems transactions between a member bank and a nonaffiliated third party as covered transactions between the bank and its affiliate to the extent that proceeds of the transactions are used for the benefit of or transferred to the affiliate. The Board has adopted an interpretation and exemptions from section 23A for certain loans made by an insured depository institution to customers who use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution acting exclusively as a broker or riskless principal in the transaction. The interpretation and final rule become effective June 11, 2001.

Additionally, the Board has adopted interim rules to address the application of sections 23A and 23B to credit exposure arising out of derivative transactions between an insured depository institution and its affiliates and intraday extensions of credit by an insured depository institution to its affiliates. The interim rules, which become effective January 1, 2002, require institutions to adopt policies and procedures reasonably designed to monitor, manage, and control credit exposures arising out of the transactions and clarify that the transactions are subject to section 23B.

The Board must receive comments on the interim rules by August 15, 2001. Please address comments to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551. Also, you may mail comments electronically to regs.comments@federalreserve.gov. All comments should refer to Docket No. R-1104.

ATTACHMENTS


MORE INFORMATION

For more information, please contact Jane Anne Schmoker, Legal Department, (214) 922-5101. For additional copies of this Bank’s notice, contact the Public Affairs Department at (214) 922-5254 or access District Notices on our web site at http://www.dallasfed.org/banking/notices/index.html.
Part II

Federal Reserve System

12 CFR Parts 223 and 250
Transactions Between Banks and Their Affiliates; Proposed Rule
Applicability of Section 23A of the Federal Reserve Act to the Purchase of Securities From Certain Affiliates; Final Rule
Loans and Extensions of Credit Made by a Member Bank to a Third Party; Final Rule
Application of Sections 23A and 23B of the Federal Reserve Act to Derivative Transactions With Affiliates and Intraday Extensions of Credit to Affiliates; Interim Rule
Transactions Between Banks and Their Affiliates

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is proposing a new rule (Regulation W) to implement comprehensively sections 23A and 23B of the Federal Reserve Act. The proposed rule would combine statutory restrictions on transactions between a bank and its affiliates with numerous existing and proposed Board interpretations and exemptions in an effort to simplify compliance with sections 23A and 23B.

DATES: Comments must be submitted on or before August 15, 2001.

ADDRESSES: Comments should refer to Docket No. R–1103 and should be sent to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551 (or mailed electronically to regs.comments@federalreserve.gov). Comments addressed to Ms. Johnson also may be delivered to the Board’s mail room between the hours of 8:45 a.m. and 5:15 p.m. weekdays and, outside of those hours, to the Board’s security control room. Both the mail room and the security control room are accessible from the Eccles Building courtyard entrance, located on 20th Street, NW., between Constitution Avenue and C Street, NW. Members of the public may inspect comments in Room MP–500 of the Martin Building between 9 a.m. and 5 p.m. weekdays, except as provided in section 261.14 of the Board’s Rules Regarding Availability of Information (12 CFR 261.14).

FOR FURTHER INFORMATION CONTACT: Pamela G. Nardolilli, Senior Counsel (202/452–3289), or Mark E. Van Der Weide, Counsel (202/452–2263), Legal Division; or Michael G. Martinson, Associate Director (202/452–3640), or Molly S. Wassom, Associate Director (202/452–2305), Division of Banking Supervision and Regulation; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Introduction

Sections 23A and 23B of the Federal Reserve Act are two of the most important statutory protections against a bank suffering losses because of its transactions with affiliates and, correspondingly, are two of the most effective means of limiting the ability of a bank to transfer its losses to the Federal safety net. Although sections 23A and 23B of the Federal Reserve Act each explicitly grant the Board broad authority to issue regulations to administer the section, the Board has never issued a regulation fully implementing either section. Instead, banks seeking guidance on how to comply with sections 23A and 23B have relied on a series of Board interpretations and informal staff guidance. Banks have increasingly sought guidance from the Board on section 23A issues in recent years as a result of the increasing scope of activities conducted by modern financial holding companies and the growing complexities of the U.S. financial markets.

The Board now believes that adoption of a comprehensive regulation implementing sections 23A and 23B would be appropriate for several reasons. First, the new regulatory framework established by the Gramm-Leach-Bliley Act (“GLB Act”) emphasizes the importance of sections 23A and 23B as a means to protect banks from losses in connection with the newly authorized affiliates under the GLB Act. In addition, the GLB Act amended section 23A in several important respects and requires the Board to address by rule under section 23A the credit exposure arising from derivative transactions and intraday credit extensions.

Moreover, the Board believes that adoption of a comprehensive regulation would simplify the interpretation and application of sections 23A and 23B, ensure that the statute is consistently interpreted and applied, and minimize burden to the extent consistent with the statute’s goals. Finally, issuing a proposed regulation would allow the public an opportunity to comment on Board and staff interpretations of sections 23A and 23B, many of which were adopted without the benefit of a public comment process.

The proposed regulation would supersede outdated Board and staff interpretations concerning sections 23A and 23B and would incorporate other existing interpretations. In addition, the regulation would incorporate the results of the Board’s earlier proposals to clarify the scope of the attribution rule, expand the section 23A(d)(6) exemption for purchases of readily marketable assets, and, consistent with the GLB Act, extend the coverage of section 23A to subsidiaries of a bank engaged in activities that the bank cannot conduct directly.

Finally, the proposed regulation would answer questions that have arisen frequently in the Board’s administration of the statutory provisions and in their enforcement by each of the Federal banking agencies.

The Board emphasizes that Regulation W is a proposed rule and expects to make changes to the rule to reflect public comments as appropriate. Until Regulation W is finalized, all previously issued valid Board interpretations and staff opinions regarding sections 23A and 23B will remain in full force and effect. After the Board issues the regulation in final form, any Board interpretations or staff opinions on the statute that are inconsistent with the regulation will be deemed superseded by the rule.

Background

As noted above, sections 23A and 23B of the Federal Reserve Act are designed to limit the risks to a bank (and the Federal deposit insurance funds) from transactions between the bank and its affiliates and to limit the ability of a bank to transfer to its affiliates the subsidy arising from the bank’s access to the Federal safety net. Section 23A achieves these goals in three major ways. First, it limits a bank’s “covered transactions” with any single “affiliate” to no more than 10 percent of the bank’s capital and surplus, and transactions with all affiliates combined to no more than 20 percent of capital and surplus. “Covered transactions” include purchases of assets from an affiliate, extensions of credit to an affiliate, investments in securities issued by an affiliate, guarantees on behalf of an affiliate, and certain other transactions that expose the bank to an affiliate’s credit or investment risk. A bank’s “affiliates” include, among other companies, any companies that control the bank, any companies under common control with the bank, and certain investment funds that are advised by the bank or an affiliate of the bank.

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

Section 23B protects a bank by requiring that certain transactions between the bank and its affiliates occur on market terms; that is, on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with unaffiliated companies. Section 23B applies this restriction to any covered transaction (as defined in section 23A) with an affiliate as well as certain other transactions, such as the sale of securities or other assets to an affiliate and the payment of money or furnishing of services to an affiliate.

Section 23A originally was enacted as part of the Banking Act of 1933 and applied only to banks that were members of the Federal Reserve System ("member banks"). Since 1933, Congress has amended the statute several times, including a comprehensive revision in 1982.4 Congress also amended the Federal Deposit Insurance Act in 1966 to extend section 23A to cover insured nonmember banks.5 In 1989, Congress further extended the coverage of section 23A to insured savings associations.6 Congress enacted section 23B of the Federal Reserve Act as part of the Competitive Equality Banking Act of 1987,7 and has subsequently expanded its scope to cover the same set of depository institutions as are covered by section 23A. Consequently, sections 23A and 23B now apply to all insured depository institutions and uninsured member banks.

As part of its comprehensive revision of section 23A in 1982, Congress amended the statute to exempt transactions between a bank and its subsidiaries.8 In 1982, a subsidiary of a bank generally was permitted to engage only in activities that its parent bank could conduct. Since 1982, however, some subsidiaries of banks have begun to engage in activities impermissible to the banks themselves.9 In 1997, to address these subsidiaries, the Board issued for comment a proposal to extend sections 23A and 23B to transactions between a bank and a subsidiary of the bank engaged in activities not permissible for the bank to engage in directly.10 Consistent with this proposal, the GLB Act recently amended the Federal Reserve Act so that sections 23A and 23B would apply to transactions between a bank and its "financial subsidiaries." Section 23A, as amended by the GLB Act, defines a financial subsidiary as any subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States.11 This statutory provision defines a financial subsidiary of a national bank as a subsidiary of an insured depository institution that engages in activities that are not permissible for a national bank to engage in directly (unless a national bank is authorized by the express terms of a Federal statute (other than the GLB Act) to own or control the subsidiary). The GLB Act provides that a financial subsidiary of a bank is considered an "affiliate" of the bank for purposes of sections 23A and 23B and requires, with certain limited exceptions, that any covered transactions between a bank and its financial subsidiaries comply with the same quantitative, collateral, and other restrictions imposed by sections 23A and 23B on other affiliates.

The GLB Act also establishes certain special rules for financial subsidiaries. For example, the GLB Act extends the restrictions of sections 23A and 23B to investments by a bank's affiliate in securities issued by any financial subsidiary of the bank. The GLB Act also authorizes the Board to extend sections 23A and 23B to loans and other extensions of credit made by a bank's other affiliates to any financial subsidiary of the bank, if the Board determines that such action is necessary or appropriate to prevent evasions of the Federal Reserve Act or the GLB Act. Finally, the GLB Act provides that the 10 percent restriction on covered transactions with any individual affiliate does not apply to transactions between a bank and any individual financial subsidiary of the bank.12 The proposed regulation addresses these provisions of the GLB Act.

In addition, the GLB Act requires the Board to adopt, by May 12, 2001, final rules to address as a covered transaction the credit exposure arising out of derivative transactions between banks and their affiliates and intraday extensions of credit by banks to their affiliates.13 Concurrently with proposed Regulation W, the Board is issuing interim final rules that address these credit exposures to affiliates as covered transactions under section 23A, in accordance with this statutory requirement, by requiring banks to adopt policies and procedures to manage the credit exposures. The interim final rules also require banks to ensure that their intraday extensions of credit to an affiliate and their derivative transactions with affiliates comply with the market terms requirement of section 23B.

The proposed Regulation W sets forth a more comprehensive proposal on the treatment of intraday extensions of credit under section 23A than is contained in the interim final rules and includes a detailed request for comment on the appropriate treatment of credit exposure arising from bank-affiliate derivative transactions under section 23A. If, after further analysis and review of the comments received on this regulation and the interim final rule on derivatives, the Board believes that additional measures are needed to address credit exposure on derivative transactions under section 23A, the Board will develop a specific proposal and seek comment on that proposal.

Explanation of Proposed Rule

I. Format of Regulation

The proposed Regulation W seeks to provide users with a single, comprehensive reference tool for complying with and analyzing issues arising under sections 23A and 23B. Accordingly, the regulation includes Board interpretations of the sections and also restates the statutory definitions, restrictions, and exemptions. Although including the statutory language lengthens the text of the regulation, the Board believes that eliminating the need to cross-reference the statute should make understanding and using the regulation easier.

The regulation first sets forth, in subpart B, the principal restrictions and requirements imposed by section 23A. Next, in subpart C, the regulation discusses the appropriate valuation and timing principles for covered transactions.
transactions. Subpart D discusses the appropriate treatment under section 23A for transactions with financial subsidiaries, bank-affiliate derivative transactions, and certain bank-affiliate merger and acquisition transactions. Subpart E sets forth available exemptions from certain of the restrictions and requirements of section 23A. Subpart F lays out the operative provisions of section 23B. Subpart G discusses the application of the statutory provisions and rule to U.S. branches and agencies of foreign banks. Subpart H provides a comprehensive glossary of the terms used in the regulation and sections 23A and 23B.

The proposed regulation also includes examples illustrating how several of the rule’s provisions would apply in particular circumstances. The examples included in the rule are considered part of the rule and compliance with an example, to the extent applicable, would constitute compliance with the rule. Each example included in the rule illustrates only the scope and application of the particular topic addressed by the example and does not illustrate any other topic or issue that may arise under the rule.

The Board requests comment on the proposed format of the regulation, including the Board’s decision to restate and reorganize the statutory provisions and include examples in the rule. The Board also requests comment on whether additional examples should be added to the rule and, if so, in what areas. In addition, the Board requests comment on whether there are additional methods for making the regulation more user-friendly or for reducing unnecessary regulatory burden.

II. Scope of Regulation

As proposed, Regulation W applies to all “banks.” As noted above, although sections 23A and 23B apply by their terms only to member banks, the Federal Deposit Insurance Act subjects insured nonmember banks to the restrictions of sections 23A and 23B as if they were member banks. Referring to banks (rather than member banks) should clarify the scope of the regulation for the reader. By using the defined term “bank,” the Board does not intend to expand the scope of sections 23A and 23B beyond member banks and insured nonmember banks.14

The Home Owners’ Loan Act (“HOLA”) also subjects insured savings associations to sections 23A and 23B as if they were member banks. HOLA imposes several restrictions on transactions between an insured savings association and certain of its affiliates that are not contained in section 23A.15 and provides the Office of Thrift Supervision (“OTS”) with authority to impose additional restrictions on transactions between an insured savings association and its affiliates.16 In light of the stricter regulatory regime governing transactions between an insured savings association and its affiliates and in light of a request by the OTS that the proposed Regulation W not specifically cover such institutions, the proposed rule does not apply by its terms to savings associations. The Board notes, however, that because insured savings associations are subject to sections 23A and 23B as if they were member banks, any parallel regulation adopted by the OTS to govern transactions with affiliates must be at least as strict on insured savings associations as Regulation W on banks.

III. General Provisions of Section 23A—Subpart B

Subpart B of the proposed regulation sets forth the principal restrictions of section 23A. These restrictions include: (i) the quantitative limits on covered transactions by a bank with any individual affiliate and all affiliates in the aggregate; (ii) the requirement that all transactions with an affiliate be on terms and conditions that are consistent with safe and sound banking practices; (iii) the collateral requirements for extensions of credit and similar transactions with an affiliate; (iv) the prohibition on the purchase of low-quality assets from an affiliate; and (v) the attribution rule, which provides that any transaction with any person that is not an affiliate will be considered a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate.

Subpart B also incorporates previous Board and staff interpretations of these provisions. In addition, the subpart includes a few new interpretations of the statute’s quantitative limits, collateral requirements, and attribution rule. These clarifications of the statute are discussed below.

A. Quantitative Limits—223.2 and 223.3

Section 23A(a)(1) provides that a bank may engage in a covered transaction with an affiliate only if, upon consummation of the proposed transaction, the aggregate amount of the bank’s covered transactions (i) with any single affiliate would not exceed 10 percent of the bank’s capital stock and surplus and (ii) with all affiliates would not exceed 20 percent of the bank’s capital stock and surplus.17 Sections 223.2 and 223.3 of the proposed regulation set forth these quantitative limits. The quantitative limits of Regulation W (consistent with section 23A) only prohibit a bank from engaging in a new covered transaction if the bank would be in excess of the 10 or 20 percent thresholds after consummation of the new transaction. The regulation (consistent with section 23A) generally does not require a bank to unwind existing covered transactions if the bank exceeds the 10 or 20 percent limits because its capital declined or a pre-existing covered transaction increased in value.

Section 23A(a)(1)(A) states that a bank “may engage in a covered transaction with an affiliate only if * * * in the case of any affiliate,” the aggregate amount of covered transactions of the bank will not exceed 10 percent of the capital stock and surplus of the bank. Regulation W makes clear that this limitation prevents a bank from engaging in a new covered transaction with an affiliate if the aggregate amount of covered transactions between the bank and any affiliate (not only the particular affiliate with which the bank proposes to engage in the new covered transaction) would be in excess of 10 percent of the bank’s capital stock and surplus after consummation of the new transaction. This interpretation of the section is consistent with the statutory language and would have the salutary effect of encouraging banks with covered transactions in excess of the 10 percent threshold with any affiliate to reduce those transactions before expanding the scope or extent of the bank’s relationships with other affiliates.

B. Collateral Requirements—223.5

Section 223.5 of the proposed regulation sets forth the collateral requirements established by section

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14 The regulation implements sections 23A and 23B of the Federal Reserve Act. The regulation does not contain or implement statutory or regulatory restrictions on transactions between banks and their affiliates that may be applicable under other provisions of law, including that may apply to banks subject to prompt corrective action under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o).
15 HOLA prohibits an insured savings association from (i) making loans or extending credit to any affiliate unless that affiliate is engaged solely in activities that the Board has determined to be permissible under section 4(c) of the Bank Holding Company Act (12 U.S.C. 1843(c); and (ii) purchasing or investing in shares issued by an affiliate other than a subsidiary of the savings association.
23A(c) for loans and extensions of credit to an affiliate, and guarantees, acceptances, and letters of credit issued on behalf of an affiliate (collectively, “credit transactions”). As a general matter, section 23A requires any credit transaction by a bank with an affiliate to be secured with a statutorily prescribed amount of collateral. The required collateral varies from 100 percent of the value of the credit extended (when the collateral is a deposit account or U.S. government securities) to 130 percent of the credit extended (when the collateral is stock, leases, or certain other “real or personal property”).

1. Deposit account as collateral—223.5(b)(1)(iv). Under section 23A(c)(1)(A)(iv), a bank may satisfy the collateral requirements of the statute by securing a credit transaction with an affiliate with a segregated, earmarked deposit account maintained with the bank in an amount equal to 100 percent of the credit extended. The proposed regulation clarifies that to satisfy the statute’s “earmarked” requirement, the account must exist for the sole purpose of securing the credit extended and be so identified.

2. Ineligible collateral—223.5(c). The purpose of section 23A’s collateral requirements is to ensure that banks that engage in credit transactions with an affiliate have legal recourse, in the event of affiliate default, to tangible assets with a value at least equal to the amount of the credit extended. The statute recognizes that certain types of assets are not appropriate to serve as collateral for credit transactions with an affiliate. In particular, the statute provides that low-quality assets and securities issued by an affiliate are not eligible collateral for such covered transactions.

In light of the purposes of section 23A, the Board believes that intangible assets (as defined by generally accepted accounting principles (“GAAP”))—including mortgage servicing assets and other servicing assets—are not acceptable collateral to secure credit transactions with an affiliate. Intangible assets are particularly hard to value, and a bank may have significant difficulty in collecting and selling such assets in a reasonable period of time. For these reasons, Board staff opined in 1987 that mortgage servicing rights may not be used to satisfy the collateral requirements of section 23A. The Board believes that these reasons continue to justify the exclusion of mortgage servicing assets, as well as other intangible assets, from the types of collateral eligible to satisfy the requirements of section 23A. The Board seeks comment on whether banks should be permitted to use any particular types of intangible assets to meet section 23A’s collateral requirements.

In addition, the Board does not consider guarantees and letters of credit to be eligible collateral for section 23A purposes. These agreements are not balance sheet assets under GAAP and, accordingly, would not constitute “real or personal property” under section 23A. Moreover, section 23A(c) requires that credit transactions be “secured” by collateral. A credit transaction between a bank and an affiliate supported only by a guarantee or letter of credit from a third party would not appear to meet the statutory requirement that the credit transaction be secured by collateral.

As noted above, section 23A prohibits a bank from accepting securities issued by an affiliate as collateral for an extension of credit to an affiliate. The Board also proposes to clarify that securities issued by the bank itself are not eligible collateral to secure a credit transaction with an affiliate. If the bank were forced to foreclose on such a credit transaction, the bank may be unwilling to liquidate its own securities promptly to recover on the credit transaction because the sale might depress the price of the bank’s outstanding securities or result in a change in control of the bank. In addition, to the extent that a bank is unable or unwilling to sell its own securities acquired through foreclosure, the transaction may result in a reduction in the bank’s capital, thereby offsetting any potential benefit provided by the collateral. The Board seeks comment on whether this exclusion should apply to debt and equity securities issued by the bank or whether the exclusion should apply only to bank-issued equity securities.

3. Perfection and priority required—223.5(d). To ensure that the bank has good access to the assets serving as collateral for its transactions with affiliates, the proposed regulation also provides that a bank’s security interest in any collateral required by section 23A must be perfected in accordance with applicable law. This requirement is consistent with court decisions on the issue and ensures that the bank has the legal right to realize on the collateral in case of default, including one resulting from the affiliate’s insolvency, liquidation, or similar circumstances.

For similar reasons, the proposed regulation requires that a bank either must obtain a first priority security interest in the required collateral or must deduct from the amount of collateral obtained by the bank the lesser of (i) the amount of any security interests in the collateral that are senior to that obtained by the bank or (ii) the amount of any credits secured by the collateral that are senior to that of the bank. For example, if a bank lends $100 to an affiliate and takes as collateral a second lien on a parcel of real estate worth $200, the arrangement would only satisfy the collateral requirements of section 23A if the affiliate owed the holder of the first lien $70 or less (a credit transaction secured by real estate must be secured at 130 percent of the amount of the transaction).

4. Undrawn portion of an extension of credit—223.5(g). Section 23A requires that the “amount” of an extension of credit be secured by the statutorily prescribed levels of collateral. Board staff traditionally has advised that a bank that provides a line of credit to an affiliate must secure the full amount of the line of credit throughout the life of the credit. That is, staff has not viewed section 23A as permitting a bank to satisfy the collateral requirements of section 23A by securing only the portion of a credit line that has been drawn down by the affiliate. The Board acknowledges that this treatment may be too strict for some lines of credit. Accordingly, the regulation provides that the collateral requirements of section 23A do not apply to the undrawn portion of an extension of credit to an affiliate so long as the bank does not have any legal obligation to advance additional funds under the credit facility until the affiliate has posted the amount of collateral required by the statute with respect to the entire drawn portion of the extension of credit. In such credit arrangements, securing the undrawn portion of the credit line is unnecessary from a safety and soundness perspective because the affiliate can never require the bank to advance additional funds without posting the additional collateral required by section 23A. If a bank voluntarily advances additional funds under such a credit arrangement without obtaining the additional collateral required under section 23A to secure the entire drawn amount (despite

19 12 U.S.C. 371c(c)(3) and (4).
22 This proposed treatment would not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate, which must be fully collateralized at inception.
its lack of legal obligation to make such an advance), the Board would view this action as a violation of the collateral requirements of the statute.

C. Prohibition on the Purchase of Low-Quality Assets—223.6

Section 223.6 of the proposed regulation restates the statute’s general prohibition on a bank purchasing low-quality assets from an affiliate.22 This section also provides an exception to the general prohibition, which is based on a long-standing staff interpretation.23 The exception allows a bank that purchased a loan participation from an affiliate to renew its participation in the loan, or provide additional funding under the existing participation, even if the underlying loan has become a low-quality asset, so long as certain criteria are met. These renewals or additional credit extensions may enable both the affiliate and the participating bank to avoid or minimize potential losses. It would be inconsistent with the purposes of section 23A to bar a participating bank from using a sound banking judgment to take the necessary steps (consistent with the criteria established in the rule) to protect itself from harm in such a situation.

The exception is available only if the underlying loan was not a low-quality asset at the time the bank purchased its participation, and the proposed transaction does not increase the bank’s proportional share of the credit facility. The transaction also must be approved by the bank’s board of directors, and the bank must provide its appropriate Federal banking agency with 20 days’ prior notice of the transaction. The notice requirement represents an additional condition to the exception that is not contained in the staff’s outstanding interpretive letter on the exception. The Board proposes to add this condition at the request of a Federal banking agency that expressed an interest in monitoring these transactions.

The Board believes that this exception allows banks appropriate flexibility to resolve problems associated with a troubled loan participation.

D. Attribution Rule—223.7

Section 23A(a)(2) provides that any transaction between a bank and a third party is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate.24 For example, a bank’s loan to a customer for the purpose of purchasing securities from the inventory of a broker-dealer affiliate of the bank would be a covered transaction under section 23A. This “attribution rule” was included in section 23A to prevent a bank from evading the restrictions in the section by using intermediaries and to limit the exposure that a bank has to customers of affiliates of the bank.

Section 223.7 of the proposed regulation restates the provision and provides interpretive guidance and exemptions on the following topics.

1. Agency and riskless principal transactions—223.7(b)(1) and (2).

In June 1998, the Board proposed several exemptions for covered transactions between a bank and its securities affiliates (the “1998 Proposal”).25 In the 1998 Proposal, the Board proposed to exempt from section 23A loans by a bank to an unaffiliated customer who uses the proceeds to purchase securities through a broker-dealer affiliate of the bank that is acting solely in an agency or riskless-principal capacity. The Board is adopting an expanded form of this exemption in a separate final rule issued concurrently with Regulation W. The Board also proposed an exemption from section 23A for extensions of credit by a bank to an unaffiliated customer that uses the credit to purchase securities underwritten by or held in the inventory of a broker-dealer affiliate of the bank when that extension of credit was made pursuant to a preexisting line of credit (the “Preexisting Line of Credit Exemption”). The Board is adopting this exemption substantially as proposed in another separate final rule issued concurrently with Regulation W. The exemption is also included in Regulation W, thus allowing an opportunity for further comment on the exemption.

2. Preexisting Lines of Credit—223.7(b)(3).

In the 1998 Proposal, the Board also proposed an exemption from section 23A for extensions of credit by a bank to an unaffiliated customer that uses the credit to purchase securities underwritten by or held in the inventory of a broker-dealer affiliate of the bank when that extension of credit was made pursuant to a preexisting line of credit (the “Preexisting Line of Credit Exemption”). The Board is adopting this exemption substantially as proposed in another separate final rule issued concurrently with Regulation W. The Board also proposed an exemption from section 23A for extensions of credit by a bank to an unaffiliated customer that uses the credit to purchase securities underwritten by or held in the inventory of a broker-dealer affiliate of the bank when that extension of credit was made pursuant to a preexisting line of credit (the “Preexisting Line of Credit Exemption”). The Board is adopting this exemption substantially as proposed in another separate final rule issued concurrently with Regulation W. The exemption is also included in Regulation W, thus allowing an opportunity for further comment on the exemption.

3. General Purpose Credit Cards—223.7(b)(4).

Section 23A’s attribution rule, by its terms, would cover an extension of credit by a bank to a nonaffiliate where the proceeds of the extension of credit are used by the nonaffiliate to purchase products or services from an affiliate of the bank. Regulation W would exempt such an extension of credit from the attribution rule if the extension is made pursuant to a general purpose credit card issued by the bank to the nonaffiliate. The regulation defines a general purpose credit card as a credit card issued by a bank, if (i) the card may be used to buy products or services from a nonaffiliate of the bank, (ii) the card is widely accepted by merchants that are not affiliates of the bank, and (iii) less than 25 percent of the aggregate amount of products and services purchased with the card by all cardholders are products or services purchased from affiliates of the bank (see § 223.26(n)). In these circumstances, the funding benefit received by the affiliate from the unaffiliated borrower’s use of the general purpose credit card is likely to be minimal, and a bank’s decision to issue a general purpose credit card (and make loans pursuant to such credit card) to an unaffiliated borrower likely would be based on independent credit standards unrelated to any possible affiliate transaction. Extensions of credit to unaffiliated borrowers pursuant to special purpose credit cards (that is, credit cards that may only be used or are substantially used to buy goods or services from affiliates of the bank), however, would continue to be subject to the attribution rule because the affiliate would be a significant and intended beneficiary of the bank’s credit extensions pursuant to the cards.

IV. Valuation and Timing Principles Under Section 23A—Subpart C

Subpart C of the proposed regulation sets forth the rules that banks must use to calculate the value of covered transactions for purposes of determining compliance with the quantitative limits and collateral requirements of section 23A. This subpart also sets forth several rules that banks must employ to determine when a transaction becomes or ceases to be a covered transaction. Although most of these valuation and timing rules are consistent with previous advice given by Board staff on these issues, certain of the principles represent new positions. The rules are discussed below.

A. Credit Transactions—223.8

The regulation provides generally that a credit transaction initially must be valued at the amount of funds provided by the bank to, or on behalf of, the affiliate plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate. For example, a $100 term loan is a $100
covered transaction, a $300 revolving credit facility is a $300 covered transaction (regardless of how much of the facility the affiliate has drawn down), and a guarantee backstopping a $500 debt issuance of the affiliate is a $500 covered transaction.

The regulation also would make clear that a bank has entered into a credit transaction with an affiliate at the time during the day that the bank becomes legally obligated to make the extension of credit to, or issue the guarantee, acceptance, or letter of credit on behalf of, an affiliate. This timing rule represents a departure from the industry practice of complying with section 23A only with respect to overnight positions. The rule is consistent, however, with the regulation’s proposal to incorporate intraday credit extensions into section 23A, as described below. This timing rule also clarifies that a covered transaction occurs at the moment that the bank executes a legally valid, binding, and enforceable credit agreement or guarantee document, and does not occur only when a bank funds a credit facility or makes payment on a guarantee.

Under section 23A and the proposed regulation, a bank has made an extension of credit to an affiliate if the bank purchases from a third party a loan previously made to an affiliate of the bank. The regulation refers to this type of transaction as an “indirect” credit transaction. In these circumstances, the bank must value the credit transaction at the price paid by the bank for the loan plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate under the terms of the credit agreement.

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

For these indirect credit transactions, the regulation requires a bank to engage in a covered transaction at the moment during the day that the bank acquires the credit transaction from the third party.

Although a bank’s purchase of, or investment in, a debt security issued by an affiliate is considered an “extension of credit” under the regulation, these transactions are not valued like other extensions of credit. The valuation rules for purchases of, and investments in, the debt securities of an affiliate are set forth in section 223.10 of the rule, which is discussed in Part IV.C. below.

Banks sometimes lend money to, or issue guarantees on behalf of, unaffiliated companies that later become affiliates of the bank. The regulation provides that credit transactions with a nonaffiliate become covered transactions at the time that the nonaffiliate becomes an affiliate of the bank. The Board does not believe that section 23A should be read to prevent the affiliation or to require that the indebtedness be reduced to meet the applicable section 23A quantitative limits before the affiliation occurs or thereafter. The bank must ensure, however, that any such credit transaction satisfies the collateral requirements of section 23A promptly after the nonaffiliate becomes an affiliate. The bank also must include the amount of any such transaction in the aggregate amount of its covered transactions for purposes of determining whether any future covered transactions would comply with the quantitative limits of section 23A.

In cases where the bank entered into the credit transaction with the nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the bank, however, there is an additional requirement. In such cases, the bank must, at or prior to the time the nonaffiliate becomes an affiliate, reduce the aggregate amount of its covered transactions with affiliates if necessary so as not to exceed the quantitative limits of section 23A. The regulation provides an example of how section 23A applies in these circumstances.

B. Asset Purchases—223.9

Regulation W provides that a purchase of assets by a bank from an affiliate initially must be valued at the total amount of consideration given by the bank in exchange for the asset. This consideration can take any form, and the regulation makes clear that it would include an assumption of liabilities by the bank. The regulation also indicates that an asset purchase remains a covered transaction for a bank for as long as the bank holds the asset, and that the value of the covered transaction after the purchase may be reduced to reflect amortization or depreciation of the asset, to the extent that such reductions are consistent with GAAP and are reflected on the bank’s financial statements. In contrast with credit transactions, an asset purchase from a nonaffiliate that later becomes an affiliate generally does not become a covered transaction for the purchasing bank. However, as set forth in the proposed rule, if a bank purchases assets from a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the bank, the asset purchase becomes a covered transaction at the time the nonaffiliate becomes an affiliate. In addition, the bank must ensure that the aggregate amount of the bank’s covered transactions (including any such asset purchase from the nonaffiliate) would not exceed the quantitative limits of section 23A at the time that the nonaffiliate becomes an affiliate.

The regulation provides several examples designed to assist banks in valuing purchases of assets from an affiliate.

C. Purchases of and Investments in Securities Issued by an Affiliate—223.10

Section 23A includes as a covered transaction a bank’s purchase of, or investment in, securities issued by an affiliate. Regulation W would require a bank to value a purchase of, or investment in, securities issued by an affiliate (other than a financial subsidiary, which is subject to special rules under the GLB Act) at the greater of the bank’s purchase price or carrying value of the securities. Under the rule, a bank that pays no consideration in exchange for affiliate securities must nevertheless value the covered transaction at no less than the bank’s carrying value for the securities. In addition, the under, if the bank’s carrying value of the affiliate securities increased or decreased after the bank’s initial investment (due to profits or losses at the affiliate), the amount of the bank’s covered transaction would increase or decrease to reflect the bank’s changing financial exposure to the

28 The Board also has determined to treat certain bank-affiliate merger and acquisition transactions as constructive asset purchases. These transactions are discussed in Part V.A. below.

29The valuation rule for investments in securities issued by a financial subsidiary is discussed in Part V.B.2. below.

30Carrying value refers to the amount at which the securities are carried on the GAAP financial statements of the bank.
affiliate, but could not decline below the amount paid by the bank for the securities.

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

Second, the definition of covered transaction in section 23A includes both a “purchase of” and an “investment in” securities issued by an affiliate. Accordingly, the statute by its terms appears to cover situations where a bank purchases securities of an affiliate and situations where a bank receives affiliate securities and pays no consideration. If the rule permitted banks to value these transactions only at purchase price, the “investment in” language of the statute would be rendered superfluous. The Board believes, therefore, that the statute’s “investment in” language indicates that Congress was concerned with a bank’s continuing exposure to an affiliate through an ongoing investment in securities issued by the affiliate. The best way to give effect to this concern and the “investments in” prong of the statutory definition is to base the value of a bank’s investment in the securities of an affiliate on the bank’s actual financial exposure to the investment (as reflected on the bank’s GAAP financial statements), even if the bank paid no consideration for the securities.

Third, amendments to section 23A made by the GLB Act indicate that the value of an investment in the securities of an affiliate under section 23A should reflect increases (or decreases) in the value of the securities caused by earnings (or losses) at the affiliate. In particular, the GLB Act defines a financial subsidiary of a bank as an affiliate of the bank, but specifically provides that the section 23A value of a bank’s investment in the securities of a financial subsidiary does not include retained earnings of the subsidiary. The negative implication from this provision is that the section 23A value of a bank’s investment in other affiliates includes the affiliates’ retained earnings, which would be reflected in the bank’s carrying value of the investment under the proposed valuation rule.

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

As noted above, the proposed rule provides that the section 23A value of a bank’s investment in affiliate securities can be no less than the amount paid by the bank for the securities, even if the carrying value of the securities declines below that amount. The Board believes that this approach, although not consistent with GAAP, is reasonable because it establishes as a floor the amount of funds actually paid by the bank for the affiliate securities. Using the bank’s purchase price for the securities as a floor for valuing the covered transaction also limits the ability of a bank to provide additional funding to an affiliate as the affiliate approaches insolvency. If the regulation were to value investments in securities issued by an affiliate strictly at carrying value, then the bank could lend more funds to the affiliate as the affiliate’s financial condition worsened, because the carrying value of the affiliate’s securities also would decline and thereby increase the bank’s exposure to additional funding under section 23A. This type of increasing support for an affiliate in distress is precisely what section 23A was intended to restrict.

The regulation provides several examples designed to assist banks in valuing purchases of and investments in the securities of an affiliate.

D. Posting Securities Issued by an Affiliate as Collateral—223.11

Section 23A defines as a covered transaction a bank’s acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company.31 This type of covered transaction has two classes: one in which the only collateral for the loan is affiliate securities; and another in which the loan is secured by a combination of affiliate securities and other collateral. Section 23A does not explain how these different types of covered transactions should be valued for purposes of determining compliance with the quantitative limits of the statute.

As a general rule, Regulation W would value covered transactions of the first class, where the credit extension is secured exclusively by affiliate securities, at the full amount of the extension of credit. This approach reflects the difficulty of measuring the actual value of typically untraded and illiquid affiliate securities, and conservatively assumes that the value of the securities is equal to the full value of the loan that the securities collateralize. This position also reflects the traditional advice given by Board staff on this issue. Regulation W proposes an exception to the general rule where the affiliate securities held as collateral have a ready market. In that case, the transaction may be valued at the fair market value of the affiliate securities. The exception grants relief from staff’s traditional position in those circumstances where the value of the affiliate securities is independently verifiable by reference to transactions occurring in a liquid market.32

Regulation W would value covered transactions of the second class, where the credit extension is secured by both affiliate securities and other collateral, at the lesser of (i) the total value of the extension of credit minus the fair market value of the other collateral and (ii) the fair market value of the affiliate securities (if the securities have a ready market). Until 1999, staff advised banks to value this class of covered transactions at the total amount of the extension of credit. In January 1999, the staff modified its position on mixed collateral loans to permit banks to value these transactions in a manner similar to the proposed rule.33

The Board believes that in situations in which a loan is secured by securities

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31 12 U.S.C. 371c(b)(7)(D). This covered transaction only arises when the bank’s loan is to a nonaffiliate. Under section 23A, the securities issued by an affiliate are not acceptable collateral for a loan or extension of credit to any affiliate. See 12 U.S.C. 371c(c)(4)). Moreover, if the proceeds of a loan that is secured by an affiliate’s securities are transferred to an affiliate by the third party borrower (for example, to purchase assets or securities from the inventory of an affiliate), the loan should be treated as a loan to the affiliate. The loan must then be secured with collateral in an amount and of a type that meets the requirements of section 23A for loans by a bank to an affiliate.

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

33 See Letter dated January 21, 1999, from J. Virgil Mattingly, General Counsel of the Board, to Bruce Moland. This letter set forth an opinion of Board staff that, for purposes of applying the quantitative limits in section 23A, such mixed-collateral loans should be valued at the lesser of (1) the total amount of the loan less the fair market value of nonaffiliate collateral (if any), or (2) the fair market value of the affiliate’s securities that are used as collateral.
of an affiliate and other collateral, it is reasonable to reflect the fair market value of the other collateral in determining whether, and to what extent, the loan should count towards the bank’s section 23A quantitative limits. Under the proposed method of calculation for mixed-collateral loans, if a loan is fully secured by nonaffiliate collateral with a fair market value that equals or exceeds the loan amount, then the loan would not be included in the bank’s quantitative limits for purposes of section 23A. If the loan is not fully secured by other collateral, then the maximum amount that the bank must count against its quantitative limits is the difference between the full amount of the loan and the fair market value of the nonaffiliate collateral. This methodology takes account of the bank’s reliance on the value of nonaffiliate collateral in a loan transaction, while also recognizing that a portion of the loan may be supported by securities issued by an affiliate.

The approach taken in Regulation W, however, is different from that of the 1999 interpretation in two respects. First, although the 1999 interpretation allows banks to use the fair market value of the affiliate securities as an upper limit on the value of the transaction regardless of the liquidity of the affiliate securities, the regulation only would allow banks to use the value of the affiliate securities as an upper limit if the affiliate securities have a ready market. If the affiliate securities do not have a ready market, a bank could understake the market value of the securities in order to shrink the size of the covered transaction. Second, the regulation’s ready market requirement would replace an implicit condition of the 1999 interpretation that only a small amount of the total collateral could be affiliate securities. The valuation rule in Regulation W would apply regardless of the amount of affiliate collateral.

The Board also notes that, under section 23A, a loan that is secured with the amount of affiliate collateral. A. Bank-affiliate Merger and Acquisition Transactions—223.12

Section 23A includes a purchase of assets from an affiliate and the purchase of, or investment in, securities issued by an affiliate within the definition of covered transaction. In the past, the Board has been required to apply these provisions to transactions where a bank directly or indirectly acquires an affiliate. There are three principal methods by which a bank acquires an affiliate. The first method is where a bank (or one of its subsidiaries that is not treated as an affiliate of the bank under section 23A (an “operations subsidiary”)) directly purchases or otherwise acquires the affiliate’s assets and assumes the affiliate’s liabilities. In this case, the transaction is treated as a purchase of assets, and the covered transaction amount is equal to the amount paid by the bank for the affiliate’s assets plus the amount of any liabilities assumed by the bank in the transaction.

The second method is where a bank (or its operations subsidiary) acquires an affiliate by merger. Because a merger with an affiliate generally results in the bank acquiring all the assets of the affiliate and assuming all the liabilities of the affiliate, this transaction is effectively equivalent to the purchase and assumption transaction described in the previous paragraph. Accordingly, the merger transaction also is treated as a purchase of assets, and the covered transaction amount is again equal to the amount paid by the bank for the affiliate’s assets (if any) plus the amount of any liabilities assumed by the bank in the transaction.

The third method involves the contribution or sale of an affiliate’s shares by the affiliate’s parent to the bank (or its operations subsidiary). The Board previously has treated these transactions as a purchase of assets covered by section 23A where the bank paid consideration for the shares or the affiliate whose shares were contributed to the bank had liabilities to any affiliate of the bank.35

The proposed rule does not alter the treatment of the first two types of transaction described above. The proposed rule does provide, however, a new treatment, which is consistent with the structure of section 23A, for the third type of transaction. The rule provides that the acquisition by a bank of securities issued by a company that was an affiliate of the bank before the acquisition is treated as a purchase of the assets of the company if (i) as a result of the transaction, the company becomes a subsidiary of the bank and ceases to be an affiliate of the bank; and (ii) the company has liabilities, or the bank gives cash or any other consideration in exchange for the securities. The rule also provides that such transactions must be valued initially at the sum of (i) the total amount of consideration given by the bank in exchange for the securities; and (ii) the total liabilities of the company whose securities have been acquired by the bank through the contribution or purchase. In effect, the rule requires banks to treat these sorts of share donations and purchases in the same manner as if the bank had purchased the assets of the transferred company at a purchase price equal to the liabilities of the transferred company (plus any separate consideration paid by the bank for the shares).

This treatment for affiliate share transfers would be consistent with the approach that section 23A takes on subsidiaries of banks and with economic and marketplace realities. Section 23A treats banks and their operations subsidiaries as a single unit. Transactions between a bank and its operations subsidiaries are not treated as covered transactions between a bank and an affiliate under section 23A; rather, they are treated as transactions entirely inside the bank. Similarly, a transaction between a bank’s operations subsidiary and an affiliate of the bank is treated as a covered transaction between the bank itself and an affiliate under section 23A. Ignoring the separate corporate form of subsidiaries of banks and treating the assets and liabilities of subsidiaries of banks as assets and liabilities of the bank itself is, therefore, consistent with the structure of section 23A. Accordingly, under section 23A, these share transfers in which an affiliate of a bank becomes a subsidiary of the bank are properly viewed as a purchase of an affiliate’s assets and an assumption of an affiliate’s liabilities by the bank.

34 See, e.g., Letter dated June 11, 1999, from Robert deV. Frierson, Associate Secretary of the Board to Mr. Robert L. Anderson. Some institutions have argued that this treatment is too strict and that a covered transaction should be deemed to occur in connection with a share contribution only if there is a net transfer of value from the bank to the affiliate (that is, if the liabilities of the transferred company exceed the value of the assets of the company). In many internal reorganizations, the Board has found that the value of the assets of the transferred company was uncertain. In addition, the transactions often were motivated by funding problems at the transferred affiliate and by a desire to use the bank’s resources to alleviate those funding needs. Soon after consummating such reorganizations, bank funds typically were used to pay down liabilities that the transferred company had to the parent holding company of the bank.

V. Other Considerations under Section 23A—Subpart D

Subpart D of the proposed rule would provide guidance to banks on three issues under section 23A: (i) merger and acquisition transactions between a bank and an affiliate; (ii) financial subsidiaries of a bank; and (iii) derivative transactions between a bank and an affiliate.

The proposed treatment for affiliate share transfers is also consistent with the Board’s supervisory experience. The Board has found that banks often operate their consolidated organizations—because of capital requirements, financial reporting requirements, and reputational risk concerns—as if the assets and liabilities of subsidiaries were actually assets and liabilities of the bank itself. Banks often attempt to shore up their subsidiaries in times of financial stress, despite the limited liability inhering in the corporate form. Accordingly, the Board proposes to treat the assets and liabilities of a subsidiary of a bank as assets and liabilities of the bank itself for purposes of section 23A.36

The proposed rule only imposes asset purchase treatment on affiliate share transfers where the company whose shares are being transferred to the bank was an affiliate of the bank before the transfer. If the transferred company were not an affiliate prior to transfer, it would not be appropriate to treat the share transfer as a purchase of the assets of an affiliate. Similarly, the rule only requires asset purchase treatment for share transfers where the transferred company becomes a subsidiary and not an affiliate of the bank through the transfer. If the company were not a subsidiary of the bank after the transfer (because, for example, the bank acquired less than 25 percent of a class of voting securities of the company) or if the company were an affiliate of the bank after the transfer (because, for example, the bank’s holding company continued to own 25 percent or more of a class of voting securities of the company or because the company became a financial subsidiary of the bank after the transfer), the Board does not believe it would be appropriate to treat the liabilities of the company as the liabilities of the bank for purposes of section 23A. In those circumstances, section 23A would not treat the bank and the transferred company as a single unit.

The Board solicits comment on whether this method of treating affiliate share transfers is appropriate.

The Board notes that it has granted numerous section 23A exemptions, on a case-by-case basis, for transactions involving the transfer (by merger, purchase and assumption transaction, or otherwise) by a holding company of one of its nonbank subsidiaries to a subsidiary bank.37 The Board typically has approved such exemptions only if certain conditions are met, including (i) the transfer of the affiliate must be the result of a one-time corporate reorganization, (ii) the entity transferring the shares to the bank must provide certain assurances concerning the quality of the assets being transferred, (iii) the disinterested directors of the bank must approve the transaction in advance, (iv) the transfer must not include any low-quality assets, and (v) the bank’s appropriate Federal banking agency and the Federal Deposit Insurance Corporation must inform the Board that they have no objection to the transaction. Banks may continue to apply to the Board for such case-by-case exemptions.

The proposed regulation contains a regulatory exemption for certain merger and acquisition transactions that result in the transfer of an affiliate to a bank. Section 223.12(d) of the regulation provides an exemption from the requirements of section 23A (other than the safety and soundness requirement) for transactions in which, for example, a bank holding company acquires the stock of an unaffiliated company and, immediately after consummation of the acquisition, transfers the shares of the acquired company to the holding company’s subsidiary bank. Although these transactions technically would be subject to the asset purchase treatment discussed in this section—and the bank would be required to value the covered transaction at the total amount of the liabilities of the acquired company (plus any consideration paid by the bank for the company)—the Board believes that it would be inappropriate to treat this transaction as a covered transaction. If the bank had acquired the unaffiliated company directly, there would be no covered transaction, and the mere fact that the bank’s holding company owned the target company for a moment in time does not change the fundamental nature of the transaction.

Accordingly, the regulation exempts these “step” transactions as long as certain conditions are met. First, the bank must acquire the target company immediately after the company becomes an affiliate (as defined by the bank’s holding company, for example). To the extent that the bank acquires the target company some time after the company becomes an affiliate, the transaction looks less like a single transaction in which the bank acquires the target company and more like two separate transactions, the latter of which involves the bank acquiring assets from an affiliate. Second, the bank must acquire the entire ownership position in the target company that its holding company acquired. If the bank were to acquire less than all the shares or assets of the target company that its holding company acquired, the transaction again would not, in effect, involve the purchase of the company by the bank. Finally, the entire transaction must comply with the market terms requirement of section 23B.

B. Financial Subsidiaries—223.13

As noted above, the GLB Act amended section 23A to treat a financial subsidiary of a bank as an affiliate of the bank and to establish several special rules that apply to transactions with financial subsidiaries. The proposed regulation combines all of the special rules that apply to transactions with financial subsidiaries in a single section.

1. Applicability of the 10 percent quantitative limit on transactions with a financial subsidiary—223.13(a). First, consistent with the GLB Act, the regulation provides that the 10 percent quantitative limit in section 23A does not apply with respect to covered transactions between a bank and any individual financial subsidiary of the bank. Accordingly, a bank’s aggregate amount of covered transactions with any individual financial subsidiary may exceed 10 percent of the bank’s capital stock and surplus. A bank’s covered transactions with its financial subsidiaries, however, are subject to the statutory and regulatory 20 percent quantitative limit. Thus, a bank may not engage in a covered transaction with any affiliate (including a financial subsidiary) if the bank’s aggregate amount of covered transactions with all affiliates (including financial subsidiaries) would exceed 20 percent of the bank’s capital stock and surplus.

2. Valuation of investments in the securities of a financial subsidiary—223.13(b). Because financial subsidiaries of a bank are considered affiliates of the bank for purposes of section 23A, purchases of and investments in the securities of a financial subsidiary are covered transactions under the statute. The GLB Act provides that a bank’s investment in its financial subsidiary, for purposes of section 23A, shall not include the retained earnings of the

36 Affiliate share transfers to a bank often are functionally equivalent to transactions in which a bank directly acquires the assets and assumes the liabilities of an affiliate, because a bank can usually merge the acquired subsidiary into itself. As noted above, in a direct acquisition of assets and assumption of liabilities, the covered transaction amount would be equal to the total amount of liabilities assumed by the bank.

financial subsidiary. In light of this statutory provision, the regulation contains a special valuation rule for investments in the securities of a financial subsidiary. Such investments must be valued at the greater of (i) the price paid by the bank for the securities; and (ii) the carrying value of the securities on the financial statements of the bank (determined in accordance with GAAP but without reflecting the bank’s pro rata share of any earnings retained or losses incurred by the financial subsidiary after the bank’s acquisition of the securities).

This valuation rule differs from the general “investment in the securities of an affiliate” valuation rule only in that the financial subsidiary rule requires, consistent with the GLB Act, that the carrying value of the investment be computed without consideration of the retained earnings or losses of the financial subsidiary since the time of the bank’s investment. As a result of this rule, the covered transaction amount for a bank’s investment in the securities of its financial subsidiary would not increase except in the event that the bank made an additional capital contribution to the subsidiary or purchased additional securities of the subsidiary.

The regulation provides several examples designed to assist banks in valuing purchases of and investments in securities issued by a financial subsidiary.

3. Anti-evasion rules—223.13(c).

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

The proposed regulation incorporates both of these provisions. The regulation also exercises the Board’s authority under the second anti-evasion rule by stating that an extension of credit to a financial subsidiary of a bank by an affiliate of the bank would be treated as an extension of credit by the bank itself to the financial subsidiary if the extension of credit is treated as regulatory capital of the financial subsidiary. An example of the kind of credit extension covered by this provision would be a subordinated loan to a financial subsidiary that is a securities broker-dealer where the loan is treated as capital of the subsidiary under the SEC’s net capital rules. The Board believes that such treatment is appropriate in these circumstances because the extension of credit by the affiliate has a similar effect on the subsidiary’s regulatory capital as an equity investment by the affiliate, which is treated as a covered transaction by the terms of the GLB Act (as described above).

The Board may find certain other extensions of credit by an affiliate to a financial subsidiary to be covered transactions under section 23A on a case-by-case basis. The Board seeks comment on the appropriateness of considering other classes of credit extensions by an affiliate to a financial subsidiary as extensions of credit by the bank to the financial subsidiary.

C. Derivative Transactions—223.14

As noted above, the GLB Act requires the Board to address as covered transactions under section 23A credit exposure arising out of derivative transactions between banks and their affiliates.

Determining the appropriate treatment for derivative transactions under section 23A is a complex and important endeavor. In light of the complexities of the subject matter and in light of the May 12, 2001, statutory schedule in the GLB Act, the Board is taking two steps to address credit exposure on bank-affiliate derivative transactions under sections 23A and 23B. First, the Board is publishing an interim rule, concurrently with Regulation W, that (i) requires, under section 23A as amended by the GLB Act, that a bank establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from the bank’s derivative transactions with affiliates and (ii) clarifies that bank-affiliate derivative transactions are subject to the market terms requirement of section 23B. The policies and procedures must at a minimum provide for monitoring and controlling the credit exposure arising from the bank’s derivative transactions with each affiliate, and all affiliates in the aggregate, and ensuring that the bank’s derivative transactions with affiliates comply with section 23B.

The second step that the Board is taking to address the credit exposure arising from bank-affiliate derivative transactions under section 23A is contained in this section of the preamble to Regulation W. This section sets forth a set of questions regarding the appropriate treatment of these transactions under section 23A. In connection with the interim rule and proposed Regulation W, the Board solicits public comment on the most appropriate treatment under section 23A of the credit exposure arising from bank-affiliate derivative transactions.

In deciding how to address under section 23A credit exposure arising from derivative transactions, the initial question to be answered is how to define the term “derivative transaction.” The Board’s interim rule on bank-affiliate derivatives defines the term by reference to the definition of “derivative contract” in the capital guidelines of the Federal banking agencies (“Capital Guidelines”). The definition contained in the Capital Guidelines covers swaps, forwards, options, and other similar contracts on an interest rate, currency, equity, or commodity. The interim rule supplements the definition contained in the Capital Guidelines by also including “any similar derivative contract, including credit derivative contracts.” This supplementation recognizes that derivative instruments evolve in response to the needs of the financial marketplace.

Other options would include defining derivative transaction by reference to the definition of “qualified financial contract” or “swap agreement” in the

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38 GLB Act section 121(b)(1) (codified at 12 U.S.C. 371c(e)(3)(B)).

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

40 GLB Act section 121(b)(1) (codified at 12 U.S.C. 371c(e)(4)).

41 The proposed regulation also provides an exception to the anti-evasion rules for transactions between a bank’s financial subsidiary and another affiliate if the other affiliate is itself a bank or savings association subject to section 23A. In that event, the anti-evasion rules are not needed because the transaction will count as a covered transaction for the affiliated bank or savings association. Without this exception, the same transaction would double count as a covered transaction both for the parent bank of the financial subsidiary and for the other affiliated institution.

42 12 CFR part 225, appendix A.III.E.1a–d.
The Board requests comment on whether the regulation should treat the entirety of a bank-affiliate derivative transaction as a loan under section 23A if any portion of the transaction is the functional equivalent of a loan or should impose loan treatment only on that portion of the transaction that functions as a loan.

The Board also asks for public comment on whether Regulation W should provide a separate treatment for any other specific types of derivatives. In particular, the Board seeks comment on whether a credit derivative between a bank and an affiliate in which the bank provides credit protection to the affiliate with respect to the affiliate’s assets should be treated as a covered transaction and made subject to all the requirements of section 23A. Such a credit derivative generates risks for the bank that closely resemble the risks incurred by a bank when it purchases assets from an affiliate. The Board notes that a credit derivative transaction is the functional equivalent of a loan by a bank to an affiliate. The Board believes that it may be appropriate to treat such a derivative transaction (or the relevant part of the transaction that functions as a loan) as a loan from the bank to the affiliate for purposes of section 23A.

The Board requests comment on whether and how Regulation W should provide additional guidance for banks on identifying derivative transactions that are, or have aspects that are, the functional equivalent of a loan. The Board understands that the Internal Revenue Service has adopted a regulation that requires financial institutions, for tax purposes, to recharacterize as loans portions of certain swap and other derivative transactions based on the significance of any nonperiodic payments provided for under the terms of the transaction.44

The Board requests comment on whether banks should be required to adopt any specific policies and procedures with respect to their derivative transactions with affiliates. These policies and procedures might include provisions that require a bank to adopt the following “best practices”: (i) entering into a legally enforceable bilateral netting agreement with each of its affiliated derivatives counterparties; (ii) revaluing its derivative transactions with affiliates on a daily basis; and (iii) collateralizing its net mark-to-market credit exposure on derivative transactions with affiliates. The Board asks for comment on the appropriateness of requiring these types of policies and procedures and on whether additional policies or procedures should be required to ensure that a bank’s derivative transactions with affiliates are conducted safely and soundly.

Third, the Board solicits comment on whether banks should be required to disclose to Federal bank supervisors or the public, on a quarterly or other periodic basis, their net credit exposure to affiliates on derivative transactions. The Board solicits comment on the types of disclosures that banks reason would be required to provide with respect to their derivative transactions with affiliates in order to assist the Federal banking agencies in monitoring and supervising such transactions.

Fourth, the Board invites comment on whether any final rule addressing bank-affiliate derivatives should impose a quantitative limit on the aggregate amount of a bank’s net credit exposure on such transactions. The rule could require that the aggregate amount of a bank’s net credit exposure on derivative transactions with affiliates not exceed some percentage of the capital stock and surplus of the bank, unless the bank obtains the prior approval of its appropriate Federal banking agency. Such a separate limit for derivatives would be in addition to the general 20 percent limit for covered transactions with all affiliates under section 23A. The Board asks for comment on whether 10 percent of the bank’s capital stock and surplus would be an appropriate size for a separate cap on net derivatives credit exposure that a bank has to affiliates. Instead of establishing a separate limit, the rule could require that a bank incorporate its net credit exposure arising from derivative transactions with affiliates into its overall section 23A quantitative limits. The Board seeks comment on the appropriateness of either of these alternatives.

Fifth, the Board asks whether banks should be required to collateralize their net derivatives credit exposure to affiliates in accordance with the collateral requirements of section 23A. Finally, in the event that the Board were to impose a quantitative limit on bank-affiliate derivative transactions (whether by establishing a separate limit for derivatives or by requiring banks to include derivatives in their overall section 23A limits), the Board seeks comment on how banks should be required to determine the amount of their derivative transactions with affiliates. One valuation option would be to require banks to value a derivative transaction with an affiliate at the current exposure of the bank to the affiliate on the transaction. Under this option, the amount of a bank’s section 23A exposure to an affiliate on a derivative transaction would be based on the mark-to-market value of the transaction for the bank. If the mark-to-market value of the transaction were negative, then the current exposure would be that mark-to-market value. If the mark-to-market value were zero or positive, the current exposure would be zero. The Board specifically asks for comment on whether mark-to-market values should be adjusted to reflect counterparty credit quality.

Another valuation option would require banks to value a derivative transaction with an affiliate at the current exposure of the bank to the affiliate on the transaction plus an estimate of the bank’s potential future exposure (“PFE”) to the affiliate on the transaction. This is the approach to measuring derivatives exposure that most banks take with third parties and that the Federal banking agencies have taken in the Capital Guidelines. The Board seeks comment on whether banks should be required to include an estimate of PFE when determining the amount of their credit exposure on bank-affiliate derivative transactions and, if so, how banks should be required to calculate PFE.

PFE could be measured in a wide variety of ways. The Capital Guidelines provide one possible methodology. Under the Capital Guidelines, a bank calculates its PFE by multiplying the notional principal amount of the derivative transaction times a conversion factor specified in the guidelines that varies depending upon the remaining maturity of the derivative transaction and the nature of the asset underlying the derivative transaction. This methodology has the benefit of being easy to calculate and of being a method that is already employed by banks for regulatory capital purposes and, consequently, eliminates the burden that would attend a requirement for a different calculation method. The methodology has the drawback of being rather insensitive to gradations of risk and rather conservative in its estimates of PFE. Another possible PFE computation methodology would be to permit banks with sophisticated internal models to use those models to calculate their PFE on bank-affiliate derivative transactions. The Board also seeks comment on whether the appropriate time horizon for estimating PFE on transactions caused by a derivative transaction is the remaining maturity of the transaction or some shorter “close-out” period.

The Board also invites comment on whether and how banks should be allowed to take into account credit risk mitigators such as collateral in determining the amount of their derivative transactions with affiliates. Under section 23A, transactions fully secured by cash on deposit or U.S. government or agency securities are generally exempt from the requirements of the statute. Outside of this exemption, the statute does not allow banks to reduce the amount of a covered transaction by securing the transaction with collateral or obtaining a third-party guarantee of the transaction. Transactions secured by municipal securities, corporate debt or equity securities, or real estate, for example, are treated the same as unsecured transactions for purposes of the quantitative limits of the statute.

The Board solicits comment on whether Regulation W should provide banks with partial credit for partially securing derivative transactions with affiliates. The Board also solicits comment on what types of collateral the regulation should recognize for the purpose of reducing the section 23A credit exposure of a bank to its affiliates on derivative transactions. As noted, the only types of collateral that have an impact on a bank’s quantitative limits under the terms of section 23A are cash on deposit and U.S. government and agency securities. The Board could use this same limited list of collateral with respect to bank-affiliate derivative transactions. The Board seeks comment on whether it should expand the list of collateral acceptable for reducing the section 23A amount of these transactions and, if so, what kinds of other collateral should be acceptable as credit risk mitigators for the transactions, and what haircuts should apply to any added collateral types.

The Board also solicits the public’s view on how, if the general 10 and 20 percent quantitative limits of section 23A are applied to bank-affiliate derivative transactions, increased credit exposure of the bank to an affiliate on a pre-existing derivative transaction should be treated. For example, a bank could be required promptly to unwind existing derivatives or other covered transactions or otherwise promptly reduce the amount of its exposure to affiliates in order to restore itself to compliance with the quantitative limits of section 23A in the event that the credit exposure on a derivative transaction causes the bank to exceed the limits. Alternatively, a bank could be allowed to retain existing derivative transactions and only be required to cease engaging in new covered transactions until the bank’s aggregate amount of covered transactions falls below the statute’s quantitative limits.

If the Board were to determine that bank-affiliate derivative transactions are subject to some sort of quantitative limit under section 23A, the Board would have to address the question of whether and how to recognize netting agreements. The Board solicits comment on whether it should recognize bilateral netting agreements when computing the amount of a bank’s derivatives credit exposure to an affiliate and, if so, whether the principles set forth in the Capital Guidelines are appropriate minimum requirements for determining what is a qualifying netting agreement.

In addition, the Board solicits comment on how often a bank should mark to market its derivative transactions with affiliates. The Board requests information on how often banks mark to market their derivative transactions with third parties and on the potential burden and benefits of requiring banks to mark to market their derivative transactions with affiliates on a daily basis.

As a more general matter, the Board invites comment on whether it is necessary or appropriate to grandfather existing derivative transactions between banks and their affiliates. The Board understands that, depending on the approach ultimately taken on bank-affiliate derivatives, bringing existing derivative transactions into compliance with Regulation W may require expensive and time-consuming adjustments to positions or renegotiation of agreements and, if existing exposures are above any quantitative limits established by Regulation W, may prevent banks from engaging in future derivative transactions with affiliates.

The Board will analyze comments on this proposal and the concurrently issued interim final rule on derivative transactions. If, based on that analysis, the Board believes additional measures are needed in this area, the Board will issue a detailed proposed rule for public comment.

VI. Exemptions—Subpart E

Section 23A specifies several types of transaction that are exempt from the statute’s quantitative and collateral requirements and other types of transaction that are exempt from the statute’s quantitative, collateral, and low-quality asset requirements.

The proposed regulation sets forth the statutory exemptions, clarifies certain of these exemptions, and exempts several additional types of transactions. The clarifications and additional exemptions are discussed below.

A. Sister-Bank Exemption—223.15(a) and (b)

Section 23A(d)(1) exempts any transaction between a member bank and a “bank” if the member bank controls 80 percent or more of the voting securities of the bank, the bank controls 80 percent or more of the voting securities of the member bank, or a company controls 80 percent or more of the

voting securities of both the member bank and the bank.48 Section 23A states that the term “bank” includes “any State bank, national bank, banking association, and trust company,” and other federal law provides that an insured savings association should be treated as a “bank” for purposes of the sister-bank exemption.49 Section 23A also provides the Board with authority to issue definitions consistent with the section as may be necessary to carry out the purposes of the section and to prevent evasions thereof.50 Regulation W proposes to clarify that the sister-bank exemption generally applies only to transactions between a bank (as defined in the regulation to mean a member bank or an insured nonmember bank), on the one hand, and an insured depository institution, on the other hand. Such an interpretation is consistent with the legislative intent behind the sister-bank exemption, which was to permit the flow of funds from one insured depository institution to another insured depository institution. In this regard, the Board notes that, under the cross-guarantee provisions of the Federal Deposit Insurance Act, an insured depository institution is generally liable for any loss incurred by the FDIC in connection with the default of a commonly controlled insured depository institution.51 Without such an interpretation of the sister-bank exemption, a bank would be able to engage in unlimited covered transactions with certain uninsured depository affiliates. Permitting a bank to provide an unlimited amount of funding to an uninsured depository affiliate would contravene one of the principal purposes of the statute—protecting the deposit insurance funds from loss.52

B. Purchases of Loans on a Nonrecourse Basis—223.15(c)

Under section 23A(d)(6), a bank may purchase loans on a nonrecourse basis from an affiliated “bank” exempt from section 23A, even if the transaction does not qualify for the sister-bank exemption under section 23A(d)(1). The proposed rule clarifies that the scope of this exemption parallels that of the sister-bank exemption by stating that this exemption applies to a bank’s purchase of a loan on a nonrecourse basis from an affiliated insured depository institution.

Section 23A(d)(6) also exempts the purchase from an affiliate of assets that have a readily identifiable market quotation. This exemption is set forth separately in the regulation for purposes of clarity and is discussed in detail below.

C. Correspondent Banking—223.16(a)

Section 23A exempts from its quantitative limits and collateral requirements any deposit by a bank in an affiliated bank or affiliated foreign bank that is made in the ordinary course of correspondent business, subject to any restrictions that the Board may impose.53 The proposed rule provides that such deposits must represent ongoing, working balances maintained by the bank in the ordinary course of conducting the correspondent business. An occasional deposit in an affiliated institution would not be in the ordinary course of correspondent business. The proposed rule also indicates that correspondent deposits in an affiliated insured savings association are exempt if they otherwise meet the requirements of the exemption.

D. Fully Secured Credit Transactions—223.16(c)

Section 23A exempts any credit transaction by a bank with an affiliate that is fully secured by obligations issued or guaranteed by the United States or its agencies or by a “segregated, earmarked” deposit account.54 The proposed rule clarifies that a deposit account meets the “segregated, earmarked” requirement only if the account exists for the sole purpose of securing the extension of credit and is so identified. This requirement would parallel the provision in section 223.5(b)(1)(iv) of the rule relating to which deposits count toward the collateral requirements of section 23A. Thus, if an earmarked deposit is sufficient to fully secure the transaction, then the transaction is exempt under this section; if the deposit represents less than full security, then the amount of the deposit counts toward the required collateral under section 223.5(b).

E. Purchases of Assets With Readily Identifiable Market Quotes—223.16(e)(1)

Section 23A(d)(6) exempts the purchase of assets from an affiliate if the assets have a “readily identifiable and publicly available market quotation” and are purchased at their current market quotation.55 The Board generally has limited the availability of this exemption (the “[d](6) exemption”) to purchases of U.S. Treasury securities, securities issued by a U.S. government agency, and assets with market prices that are recorded in widely disseminated publications such as newspapers with a national circulation. Because only exchange-traded assets are recorded in such publications, the test ensures that the qualifying assets are traded actively enough to have a true “market quotation” and that examiners can verify that the assets are purchased at their current market quotation. Regulation W codifies this Board interpretation of the (d)(6) exemption and clarifies that the exemption applies to a bank’s purchase of assets having a readily identifiable and publicly available market quotation if the assets are purchased at or below the asset’s current market quotation.

F. Purchases of Securities With a Ready Market From a Securities Affiliate—223.16(e)(2)

The Board proposed in its 1998 Proposal to exempt from section 23A the purchase by a bank of certain types of securities from a securities affiliate.56 The Board has determined to adopt a somewhat revised form of this expanded (d)(6) exemption in a separate final rule being issued concurrently with Regulation W. Regulation W also contains this exemption, and the Board seeks further comment on the scope and conditions of the exemption. In particular, the Board solicits the views of the public on (i) whether the exemption should be limited to purchases from registered U.S. securities broker-dealers; (ii) whether it would be appropriate to use independent dealer quotations to establish a market price for a security under the exemption; and (iii) whether it would be appropriate to use a bank to use the exemption to purchase asset-backed securities issued by an affiliate of the bank or to purchase securities

49 12 U.S.C. 1815(e).
50 12 U.S.C. 1815(e).
51 12 U.S.C. 1815(e).
52 12 U.S.C. 1815(e).
56 63 FR 32768, June 11, 1998.
issued by a mutual fund advised by the bank or an affiliate of the bank.

G. Purchasing Municipal Securities—223.16(f)

The Board also proposes to exempt a bank’s purchase of municipal securities from an affiliate, if the purchase meets a revised and somewhat shorter version of the requirements applicable to the expanded (d)(6) exemption contained in section 223.16(e)(2) of the proposed rule.57 First, as in the expanded (d)(6) exemption, the bank must purchase the municipal securities from a broker-dealer affiliate that is registered with the SEC. Second, also as in the expanded (d)(6) exemption, the municipal securities must be eligible for purchase by a State member bank and the bank must report the transaction as a securities purchase in its Call Report. Third, the municipal securities must either be rated by a nationally recognized statistical rating organization or must be part of an issue of securities that does not exceed $25 million in size. Finally, the price for the securities purchased must be (i) quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks, (ii) verified by reference to two or more actual independent dealer quotes on the securities to be purchased or securities that are comparable to the securities to be purchased, and (iii) in the case of the securities purchased during the underwriting period, verified by reference to the price indicated in the syndicate manager’s written summary of the underwriting.58 Under any of the three pricing options, the bank must purchase the municipal securities at or below the quoted or verified price.

The Board believes that this streamlined set of requirements for purchases of municipal securities is appropriate because municipal obligations generally have a lower default risk than the other instruments whose quotations would be difficult to obtain, such as emerging market and high yield debt. In addition, these relaxed requirements are consistent with the expressed desire of Congress to support local communities’ use of municipal securities to help meet their financing needs.

H. Purchases of Assets by De Novo Banks—223.16(h)

The proposed rule would exempt a purchase of assets by a newly chartered bank from an affiliate if the appropriate Federal banking agency for the bank approved the transfer. This exemption would allow companies to charter a de novo bank and to transfer assets to the bank from its affiliates outside the restrictions of section 23A.59 Currently, if a company (usually a bank holding company) establishes a credit card bank or a trust company, the newly chartered institution cannot acquire a critical mass of assets from an affiliate because of the quantitative limits and other requirements of section 23A. The Board has received many comments that these restrictions are burdensome and unnecessary because the chartering authority for the new bank reviews the transaction (or in the case of a bank holding company, the Board also reviews the transaction) to ensure that the transfer does not result in any safety or soundness problems. For this reason, the Board has proposed the exemption.

I. Transactions Approved Under the Bank Merger Act—223.16(i)

The Board previously has exempted from section 23A any merger or consolidation transaction between affiliated insured depository institutions if the transaction has been approved by the appropriate Federal banking agency pursuant to the Bank Merger Act.60 The proposed rule includes this exemption.

J. Purchases of Extensions of Credit—223.16(j)

Section 23A includes as a covered transaction a purchase of assets from an affiliate, except such purchases of real and personal property as may be specifically exempted by the Board by order or regulation.61 In 1979, the Board issued a formal interpretation that exempted a bank’s purchase of a mortgage note or participation therein from a mortgage banking affiliate, provided that the bank’s commitment to purchase is (i) obtained by the affiliate within the context of each proposed loan, (ii) obtained prior to the affiliate’s commitment to make each loan, and (iii) based upon the bank’s independent evaluation of the creditworthiness of each mortgagor (the “250.250 exemption”).62 Although this interpretation did not impose a strict dollar limit on the amount of an affiliate’s mortgage loans that a bank could purchase under the exemption, the interpretation cautioned that the purpose of the exemption was to allow a bank to take advantage of an investment opportunity and not to provide all the working capital needed by an affiliate.

By 1995, some bank holding companies were using the 250.250 exemption extensively to fund their lending affiliates. In these cases, banks were providing all or nearly all of their affiliates’ funding needs. In response, staff indicated in an interpretive letter that the 250.250 exemption was not available if the dollar amount of the bank’s purchases from the affiliate represented more than 50 percent of the total dollar amount of loans originated by the affiliate.63 Staff reasoned that, in these circumstances, the asset purchases look less like the bank taking advantage of an investment opportunity brought to it by the affiliate and more like the bank providing an ongoing funding mechanism for the affiliate. Staff intended that this restriction would require the affiliate to have alternative funding sources and reduce the pressure on the bank to purchase the affiliate’s extensions of credit.

The proposed rule incorporates the 250.250 exemption and formally expands the exemption to cover the purchase of any type of loan or extension of credit from an affiliate. Regulation W also includes staff’s 50 percent test and another test designed to ensure that the bank is not a principal ongoing funding source for the affiliate. In particular, the rule provides that the 250.250 exemption is unavailable if (i) the amount of the bank’s total purchases from the affiliate, when aggregated with all other assets purchased from the affiliate by affiliated banks and insured savings associations, represents more than 50 percent of the credit portfolio of the affiliate; or (ii) the bank and its affiliated banks and insured savings associations provide substantial, ongoing funding to the affiliate. The Board recognizes that the “substantial, ongoing funding” condition may create some uncertainty for banks, but believes that the condition would provide examiners with additional flexibility to stop arrangements in which a bank provides a significant amount of

57 The regulation defines municipal securities by reference to section 3(a)(29) of the Securities Exchange Act, which defines municipal securities as direct obligations of, or obligations guaranteed as to principal or interest by, a State or agency, instrumentality, or political subdivision thereof, and certain tax-exempt industrial development bonds. 17 U.S.C. 78c(a)(29).

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

59 The Board also would not consider such transfers to be subject to the requirements of section 23B.

60 12 CFR 241.


62 12 CFR 250.250.

63 See Letter dated April 24, 1995, from J. Virgil Mattingly, General Counsel of the Board, to Jeffrey C. Gerrish.
funding to an affiliated lending company but does not provide a majority of the affiliate’s working capital. The Board seeks comment on whether the regulation should contain staff’s 50 percent test or the “substantial, ongoing funding” test.

The Board also seeks comment on whether the rule should limit the amount of assets that a bank may purchase from an affiliate pursuant to the 250.250 exemption to some percentage of the bank’s total assets. The Board recently reviewed a case where a nonbanking company proposed to charter a bank for the sole purpose of purchasing loans or leases from the nonbanking company. In these circumstances, a bank’s credit underwriting process may be compromised as a result of the complete dependence of the bank on the affiliate for asset growth. Prohibiting a bank from using the 250.250 exemption to purchase loans or leases from the affiliate may not be sufficient to prevent such compromises.

The Board notes that the 250.250 exemption only applies to the initial purchase of assets by the bank and not any covered transaction that may result from the bank’s ongoing holding of the asset purchased. For example, if a bank purchases from the selling affiliate a loan originated by the selling affiliate to a second affiliate, the exemption may exempt the bank’s purchase of the loan, but it would not exempt the ongoing extension of credit by the bank to the second affiliate that results from the purchase.

To qualify for this exemption, a bank must independently review the creditworthiness of each obligor prior to committing to purchase each loan. The Board does not believe that a bank can satisfy this requirement by simply having its affiliates use the bank’s underwriting standards or the underwriting standards of the Federal National Mortgage Association or any other government agency or government-sponsored enterprise. The bank must itself review and approve each loan prior to giving a purchase commitment to its affiliate. Consistent with the Board’s published interpretation on this exemption, the bank also must not make a legally enforceable blanket advance commitment to purchase a stipulated amount of loans from the affiliate.

K. Intraday Extensions of Credit—223.16(k)

As noted above, the GLB Act requires the Board to “address as covered transactions credit exposure arising out of * * * intraday extensions of credit” by banks to their affiliates. Banks regularly provide transaction accounts to their affiliates in conjunction with providing payment and securities clearing services. As in the case of unaffiliated commercial customers, these accounts are subject to overdrafts during the day that are repaid in the ordinary course of business. The Board has not to date ruled on whether these or other types of intraday credit extensions are covered transactions under section 23A or are subject to the market terms requirement of section 23B. Industry practice does not treat an intraday credit extension as subject to sections 23A or 23B unless the extension remains outstanding at the end of the day.64

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

Regulation W would provide that an intraday extension of credit is not subject to the quantitative limits or collateral requirements of section 23A if the credit extension arises in connection with the performance by a bank, in the ordinary course of business, of securities clearing and settlement transactions or payment transactions (for example, wire transfers, check clearing, and ACH transactions) on behalf of an affiliate, and the bank (i) has no reason to believe that the affiliate

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

will have difficulty repaying the extension of credit in the ordinary course of business; (ii) establishes limits on the net amount of intraday credit that the bank may extend to affiliates; and (iii) establishes and maintains policies and procedures for assessing affiliate credit quality, monitoring each affiliate’s compliance with the established limits, reviewing intraday credit extensions to an affiliate in the event of the affiliate’s violation of the limits, and ensuring that intraday credit received by each affiliate complies with section 23B. The bank also must maintain records and supporting information that are sufficient to enable the appropriate Federal banking agency for the bank to review the position limits and required policies and procedures.

Intraday extensions of credit by a bank to an affiliate that do not meet the conditions set forth above would be subject to the quantitative, collateral, and other requirements of section 23A. All intraday extensions of credit by a bank to an affiliate, including those that meet the conditions set forth above, would be subject to the market terms requirement of section 23B.

Under Regulation W, all intraday credit extensions (on a worldwide basis) that exist at the end of the bank’s business day in the United States would become subject to section 23A at that time. The Board requests comment on whether the regulation should adopt a different rule for determining when an “intraday” exposure become an “overnight” exposure. In particular, the regulation could provide that an “intraday” exposure becomes an “overnight” exposure at the end of the bank’s business day in the local jurisdiction in which the credit was extended.65

The Board may adopt a different approach to intraday credit under section 23A if it finds that banks are not implementing satisfactory controls to measure, monitor, and limit intraday credit extensions to affiliates. The Board requests comment on prudent risk management measures for intraday credit exposures.

The Board also requests comment on whether the Board should find that other types of intraday credit, not related to payment transactions or securities clearing and settlement

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65 If the Board were to take this approach, the regulation may also have to require that a bank not transfer any intraday credit extensions to other jurisdictions. Such a requirement may be necessary to prevent a bank from cycling its “intraday” transactions around the world to prevent them from ever becoming “overnight” exposures.
transactions effected through an 
affiliate’s transaction accounts at the 
bank, should be exempt from the 
quantitative limits and collateral 
requirements of section 23A. In 
particular, the Board understands that 
some credit card banks issue special 
purpose credit cards that customers may 
use only at affiliates of the bank. These 
banks extend credit on an intraday basis 
to their credit card customers to enable 
the customers to purchase goods or 
services from the banks’ affiliates. At the 
end of the day, however, many of these 
banks sell their credit card receivables 
to a third party or to another affiliate to 
prevent the extensions of credit from 
becoming overnight credits subject to 
section 23A. These intraday credit 
extensions would be covered 
transactions subject to all the 
requirements of section 23A under 
Regulation W.66

Finally, the Board requests comment 
on how long a transition period banks 
need to put the necessary policies and 
procedures in place in order to take 
avantage of the exemption for intraday 
credit extensions.

VII. General Provisions of Section 23B–
Subpart F

Subpart F of the proposed regulation 
sets forth the principal restrictions of 
section 23B. These include (i) the 
requirement that certain transactions 
between a bank and its affiliates be on 
terms and circumstances that are 
substantially the same as those 
prevailing at the time for comparable 
transactions with nonaffiliates; (ii) the 
restriction on a bank’s purchase as 
fiduciary of assets from an affiliate; (iii) 
the restriction on a bank’s purchase, 
during the existence of an underwriting 
syndicate, of any security if a principal 
underwriter of the security is an 
affiliate; and (iv) the prohibition on a 
bank’s or its affiliate’s publishing an 
advertisement or entering into an 
agreement stating that the bank will be 
responsible for the obligation of its 
affiliates. For the most part, subpart F 
restates the operative provisions of 
section 23B, and these provisions are 
not discussed below. The remainder of 
this section highlights four areas in 
which Regulation W provides additional 
guidance on section 23B.

A. Transactions Exempt from Section 
23B–223.19(a)(1)

The market terms requirement of 
section 23B applies to, among other 
transactions, any “covered transaction” 
between a bank and an affiliate. Section 23B(d)(3) makes clear that the 
term “covered transaction” in section 
23B has the same meaning as the term 
“covered transaction” in section 23A, 
but does not include any transaction that is exempt under section 23A(d)–for 
example, transactions between sister 
banks, transactions fully secured by a 
deposit account or U.S. government 
securities, and purchases of assets from 
an affiliate at a readily identifiable and 
publicly available market quotation. The 
regulation also excludes from section 
23B any covered transaction that is 
exempt from section 23A under section 
223.17(b) or (i) of Regulation W (that is, asset purchases by a de novo bank and 
transactions approved as part of a bank 
merger). The Board is proposing to 
exclude from section 23B this additional 
set of transactions because, in each case, 
the appropriate Federal banking agency 
for the bank involved in the transaction 
would be expected to ensure that the 
terms of the transaction are not 
unfavorable to the bank.

B. Purchases of Securities For Which an 
Affiliate is the Principal Underwriter– 
223.20(b)

The GLB Act amended section 23B in 
one respect. Since its passage in 1987, 
section 23B(b)(1)(B) has prohibited a 
bank, whether acting as principal or 
fiduciary, from purchasing securities 
during the existence of an underwriting 
syndicate if a principal underwriter of the securities is an 
affiliate of the bank.68 Prior to the GLB Act, a bank could escape 
this prohibition only if a majority of the inside directors of the bank approved 
the securities purchase before the 
securities were initially offered to the 
public.70 The GLB Act permits a bank to 
purchase securities during an 
underwriting conducted by an affiliate if 
the following two conditions are met. 
First, a majority of the directors of the 
bank (with no distinction drawn 
between inside and outside directors) 
must approve the securities purchase 
before the securities were initially 
ofered to the public. Second, such 
approval must be based on a 
determination that the purchase would 
be a sound investment for the bank 
irrespective of the fact that an affiliate 
of the bank is a principal underwriter of the 
securities.71 The proposed 
regulation incorporates this new 
standard and clarifies that if a bank 
proposes to make such a securities 
purchase in a fiduciary capacity, then 
the directors of the bank must base their 
approval on a determination that the 
purchase is a sound investment for the 
person on whose behalf the bank is 
acting as fiduciary.

Obviously, a bank may satisfy this 
director approval requirement by 
obtaining specific prior director 
approval of each securities acquisition 
otherwise prohibited by section 
23B(b)(1)(B). The regulation clarifies, 
however, that a bank also may satisfy 
this director approval requirement if a 
majority of the directors of the bank 
approve appropriate standards for the 
bank’s acquisition of securities 
otherwise prohibited by section 
23B(b)(1)(B) and each such acquisition 
meets the standards adopted by the 
directors. In addition, a majority of 
the bank’s directors must periodically 
review such acquisitions to ensure that 
they meet the standards and must 
periodically review the standards to 
ensure they meet the “sound 
investment” criterion of section 23B. 
The appropriate period of time between 
reviews would vary depending on the 
scope and nature of the bank’s program, 
but such reviews should be conducted 
by the directors at least annually. Prior 
to the passage of the GLB Act, Board 
staff informally allowed banks based on 
the legislative history of section 23B, 
to meet the director approval requirement 
in this fashion, and there is no 
indication that Congress in the GLB Act 
itended to alter the procedures that a 
bank could use to obtain the requisite 
director approval.72

For these reasons, the proposed 
regulation would codify staff’s 
preexisting approach to the director 
approval requirement. The Board seeks 
comment on whether this approach 
remains appropriate in light of the 
amendment made to section 23B by the 
GLB Act.

66 Other credit card banks avoid section 23A by 
securizing their receivables with a segregated, 
emar ked deposit account.

67 Under section 23A and the proposed rule, an 
extension of credit by a bank to a third party where 
the proceeds of the transaction are used for 
the benefit of, or transferred to, an affiliate of the bank 
is a covered transaction between the bank and the 


70 Many smaller banking organizations had 
difficulty meeting this standard because most or all 
of their banks’ directors were officers or employees of 
the banks or affiliates of the banks.

71 GLB Act section 738 (codified at 12 U.S.C. 
371c–1(b)(2)).

72 The Conference Report accompanying the 
Competitive Equality Banking Act of 1987 stated 
that the prior approval requirement of section 
23B(b)(2) could be met “by the establishment in 
advance of specific standards by the outside 
directors for such acquisitions. If the outside 
directors establish such standards, they must 
regularly review acquisitions to assure that the 
standards have been followed, and they must 
periodically review the standards to assure that 
they continue to be appropriate in light of market 
and other conditions.” H.R. Conf. Rep. No. 100– 
261, at 113 (1987).
their terms only to member banks of the Federal Reserve System, and other federal banking laws have made insured nonmember banks and insured savings associations subject to the sections. Federal banking law generally does not subject the U.S. branches and agencies of foreign banks to sections 23A and 23B.

Section 114(b)(4) of the GLB Act grants the Board authority to impose restrictions or requirements on relationships or transactions between a branch, agency, or commercial lending company of a foreign bank in the United States and any affiliate in the United States of such foreign bank. The Board may impose such prudential limits if the Board finds that the limits are appropriate to prevent an evasion of certain Federal banking laws, avoid a significant risk to the safety and soundness of depository institutions or any Federal deposit insurance fund, or avoid other adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.

The Board has for years imposed certain of the requirements of sections 23A and 23B on transactions between a U.S. branch or agency of a foreign bank and its U.S. affiliates engaged in underwriting and dealing in bank-eligible securities (“section 20 affiliates”).77 The Board also recently applied sections 23A and 23B to transactions between a U.S. branch or agency of a foreign bank and any affiliate of such foreign bank directly engaged in the following financial activities newly authorized under the GLB Act: (i) insurance underwriting pursuant to section 4(k)(4)(B) of the BHCA; (ii) securities underwriting and dealing pursuant to section 4(k)(4)(B) of the BHCA; (iii) merchant banking investment activities pursuant to section 4(k)(4)(H) of the BHCA; or (iv) insurance company investment activities pursuant to section 4(k)(4)(I) of the BHCA.78

The regulation also would apply these restrictions to transactions between a U.S. branch or agency of a foreign bank and any subsidiary of an affiliate directly engaged in the four activities set forth above (regardless of whether the subsidiary itself engages in any of the four activities).79 In addition, the regulation would apply sections 23A and 23B to transactions between a U.S. branch or agency of a foreign bank and any portfolio company controlled by the foreign bank under the GLB Act’s merchant banking or insurance company investment authorities. The regulation would not apply sections 23A or 23B to transactions between a U.S. branch or agency and any other type of affiliate (e.g., foreign affiliates or U.S. affiliates engaged in nonbanking activities under section 4(c)(6) of the BHCA), or to transactions between the foreign bank’s non-U.S. offices and its U.S. affiliates.

Applying the restrictions of sections 23A and 23B to transactions between the U.S. branches and agencies of foreign banks and the indicated U.S. affiliates may help to ensure maintenance of a competitive playing field between U.S. banks and foreign banks operating in the United States. The issue of competitive equity arises most strongly in connection with those activities that a U.S. bank cannot engage in directly or through an operations subsidiary. A U.S. bank may affiliate itself with a company engaged in the newly authorized financial activities listed above only if the company is a holding company affiliate of the bank or, in some cases, a financial subsidiary of the bank.80 In either case, covered transactions between the U.S. bank and the company would be subject to sections 23A and 23B. Without Regulation W’s extension of the scope of these statutory provisions, a foreign

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

Subpart G discusses the application of sections 23A and 23B to U.S. branches and agencies of foreign banks. As noted above, sections 23A and 23B apply by

77 The Board’s Operating Standards for section 20 affiliates require (i) any intraday extensions of credit by a U.S. branch or agency of a foreign bank to its section 20 affiliates to comply with the market terms regulation of section 23B; (ii) any extensions of credit by a U.S. branch or agency of a foreign bank to its section 20 affiliates and any purchase by such branch or agency of securities for which a section 20 affiliate is the principal underwriter to comply with sections 23A and 23B; and (iii) a U.S. branch or agency of a foreign bank to refrain from advertising or suggesting that it is responsible for the obligations of a section 20 affiliate, consistent with section 23B(c). See 12 CFR 225.200; 62 FR 45295, Aug. 27, 1997.


79 See 12 CFR 1843(k)(4)(B), (E), (H), and (I).

80 The regulation covers subsidiaries of affiliates directly engaged in the four activities in order to prevent evasion. If these subsidiaries were not covered, the U.S. branch of a foreign bank could fund the foreign bank’s U.S. insurance underwriter outside the scope of sections 23A and 23B by, for example, lending money to a subsidiary of the underwriter and having the subsidiary dividend or on-lend the loan proceeds to the underwriter.

81 Regulation W, consistent with the merchant banking rule, would impose sections 23A and 23B to transactions between a U.S. branch or agency of a foreign bank and its U.S. merchant banking affiliate only to the extent the proceeds of the covered transaction are used for the purpose of funding the affiliate’s merchant banking activities.
bank’s U.S. branch or agency could fund and engage in transactions with these types of affiliates more freely than could a U.S. bank. To the extent that a foreign bank’s U.S. branches and agencies are able to fund these types of U.S. affiliates outside of the restrictions of sections 23A and 23B, the affiliates are able to compete for business in the United States with a potential advantage not available to the affiliates of U.S. banks.

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

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

The regulation also provides that the Board may add to the list of affiliates of a foreign bank that are subject to the restrictions of sections 23A and 23B. The Board intends generally to use this reserved authority to ensure competitive equity between foreign banks and U.S. banks with respect to affiliates engaged in the United States in new activities that the Board may authorize for financial holding companies.

The Board also has considered the issue of how to calculate the capital stock and surplus of a foreign bank’s U.S. branch or agency for purposes of section 23A. In light of the fact that foreign banks do not separately capitalize their U.S. branches or agencies, the Board defines the capital stock and surplus of such branches and agencies by reference to the capital of the foreign bank as calculated under its home country capital standards. This definition is consistent with the approach recently adopted by the Board in its merchant banking rule,82 and represents a relaxation from the Board’s current position with respect to foreign banks that operate section 20 companies in the United States.83

IX. Definitions—Subpart H

Subpart H of Regulation W sets forth definitions of the terms used in sections 23A and 23B and in the proposed rule. Terms that are defined in the regulation as they are defined in the statute generally are not discussed below. Terms that the Board proposes to define or clarify for purposes of the regulation are discussed below.

A. Definition of Affiliate—223.24

1. Investment funds advised by the bank or a bank affiliate—223.24(a)(6).

Section 23A includes as an affiliate any company that is sponsored and advised by the bank or any of its affiliates.84 Section 23A also includes as an affiliate any investment company for which the bank or its affiliate serves as an investment advisor, as defined in the Investment Company Act of 1940 (“1940 Act”).85 The proposed regulation sets forth these definitions and also includes as an affiliate any investment fund—even if not an investment company for purposes of the 1940 Act—for which the bank or an affiliate of the bank serves as an investment advisor, if the bank or an affiliate of the bank owns or controls more than 5 percent of any class of voting securities of the fund.

Most investment funds that are advised by a bank (or an affiliate of a bank) are affiliates of the bank under section 23A because the funds either are investment companies under the 1940 Act or are sponsored by the bank (or an affiliate of the bank).86 In other instances, however, the bank or its affiliate may advise but not sponsor an investment fund that is not an investment company under the 1940 Act. Although such a fund would not fit within the statutory definition of affiliate, section 23A also authorizes the Board to determine, by regulation or order, that any company is an affiliate of a bank if the company has “a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with the company may be affected by the relationship to the detriment of the member bank or its subsidiary.”87

The Board believes that the advisory relationship of a bank or affiliate with an investment fund presents the same potential for conflicts of interest regardless of whether the fund is or is not treated as an investment company for purposes of the 1940 Act.88 An investment fund typically escapes from the definition of investment company under the 1940 Act because it (i) sells interests only to a limited number of investors or only to sophisticated investors; or (ii) invests primarily in financial instruments that are not securities.89 The Board does not believe that the private nature or investment strategy of a fund should have a substantial effect on the fund’s affiliate status under section 23A because these factors do not alter the conflicts of interest presented in the advisory relationship between the bank or its affiliate and the fund.90

The Board seeks comment on the appropriateness of treating investment funds as affiliates of a bank under certain circumstances, may be excluded from the definition of commodity pool operator. See 7 CFR 5.4.

88 In fact, a bank may face greater risk from the conflicts of interest arising from its relationships with an investment fund that is not registered as an investment company under the 1940 Act than with a registered investment company because the 1940 Act restricts transactions between a registered investment company and entities affiliated with the company’s investment adviser.
89 The term “investment company” in the 1940 Act does not include a company that is owned by qualified persons or by no more than 100 persons, provided that the company does not engage in a public offering of its securities. See 15 U.S.C. 80a–3(a)(11). (7). The term also generally does not include investment funds that are engaged primarily in investing in financial instruments other than securities. See 15 U.S.C. 80a–3(a)(11).
90 The Board also believes that investment funds organized outside the United States for which a bank or affiliate serves as investment advisor are affiliates of the bank for purposes of section 23A. See Letter dated July 24, 1990, from J. Virgil Mattingly, General Counsel of the Board, to Anne B. McMillen. The term “investment company” in the 1940 Act does include investment funds organized under the laws of a non-U.S. jurisdiction.
section 23A if the bank or its affiliate serves as investment advisor to the fund and owns more than 5 percent of any class of voting securities of the fund. The Board particularly seeks comment on whether such investment funds should be treated as affiliates only if the advising bank or affiliate owns more than 5 percent of a class of voting securities of the fund.

The Board is considering adding to the definition of “affiliate” any company controlled by an investment fund that is an affiliate of the bank. The conflicts of interest that exist between a bank and any investment fund that it or its affiliate advises also would appear to exist between the bank and a portfolio company controlled by such a fund. The Board invites public comment on this issue.

2. Financial subsidiaries—223.24(a)(8); 223.26. Section 23A defines an affiliate of a bank to include any company that controls the bank and any company that is under common control with the bank. Since 1982, however, section 23A has excluded from the definition of affiliate any subsidiary of the bank (other than a bank subsidiary) unless the Board determines by regulation or order that the subsidiary should be considered an affiliate. In 1997, the Board issued for comment a proposal to extend section 23A to covered transactions between a bank and a subsidiary of the bank engaged in activities not permissible for the bank to engage in directly.

Consistent with this proposal, the GLB Act recently amended section 23A to cover transactions between a bank and its “financial subsidiaries.” The GLB Act defines a financial subsidiary as any subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States. Section 5136A of the Revised Statutes, in turn, defines a financial subsidiary of a national bank as any company that is controlled by one or more insured depository institutions, other than a subsidiary that (i) engages solely in activities that national banks are permitted to engage in directly (and subject to the same terms and conditions as apply to national banks) or (ii) a national bank is specifically authorized by the express terms of a federal statute (other than section 5136A), and not by implication or interpretation, to control. The GLB Act provides that a financial subsidiary of a bank is considered an affiliate of the bank for purposes of section 23A.

Regulation W specifically provides, consistent with the GLB Act, that a financial subsidiary of a bank is an affiliate of the bank. The proposed regulation includes a definition of financial subsidiary that is identical to the definition of financial subsidiary set forth in section 23A, as amended by the GLB Act. The Board notes that many state banks have authority to engage directly in activities that would not be permissible for a national bank and seeks comment on how the definition of financial subsidiary should be applied to subsidiaries of state banks, including general insurance agency subsidiaries and real estate investment and development subsidiaries.

The definition of financial subsidiary in section 23A and Regulation W would cover some subsidiaries of banks that are engaged only in agency activities. The Board invites public comment on the appropriateness of exempting such subsidiaries from the definition of financial subsidiary in the regulation. Regulation W also provides that any subsidiary of a bank’s financial subsidiary will be considered a financial subsidiary of the bank, even if the subsidiary would not otherwise qualify as a financial subsidiary. The Board believes that treating such companies as financial subsidiaries is consistent with the anti-evasion provisions that the GLB Act added to section 23A and will help prevent banks from avoiding the special restrictions that the GLB Act placed on a bank’s transactions with its financial subsidiaries.

3. Companies held under merchant banking or insurance company investment authority—223.24(a)(9). The GLB Act amended the BHC Act to permit bank holding companies and foreign banks that qualify as financial holding companies to engage in merchant banking and insurance company investment activities. If a financial holding company owns or controls more than 25 percent of a class of voting shares of a company under the merchant banking or insurance company investment authority, the company is an affiliate of any bank controlled by the financial holding company by operation of the statutory definitions contained in section 23A. The GLB Act also added paragraph (b)(11) to section 23A, which creates a rebuttable presumption that a company is an affiliate of a bank for purposes of section 23A if the bank is affiliated with a financial holding company and the financial holding company owns or controls 15 percent or more of the equity capital of the company pursuant to the financial holding company’s merchant banking or insurance company investment authority. The proposed regulation includes within the definition of “affiliate” any company subject to this rebuttable presumption. The regulation also provides a definition of equity capital, identifies three situations or “safe harbors” where the statute’s presumption of control would be deemed to be rebutted, and clarifies the application of the presumption to private equity funds.

The statute does not provide a definition of equity capital. The regulation defines equity capital roughly in accordance with the GAAP definition of stockholders’ equity. Equity capital includes a company’s perpetual preferred stock, common stock, capital surplus, retained earnings, and accumulated other comprehensive income, less treasury stock. The definition of equity capital also makes clear that any other account of the company that constitutes equity should be included in the company’s equity capital. Accordingly, the Board retains its authority on a case-by-case basis to require a holding company to treat a subordinated debt investment in a company as equity capital of the company for purposes of applying the presumption of control. The Board asks for comment on whether the proposed definition of equity capital is appropriate.

The regulation also provides three specific regulatory safe harbors from the statute’s presumption of affiliate status. These safe harbors apply in situations where the holding company owns or controls more than 15 percent of the total equity of the company under the merchant banking or insurance company investment authority (thereby triggering the statutory presumption) and less than 25 percent of any class of voting securities of the company (thereby not meeting the statutory definition of control). The three situations are substantially identical to

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93 12 U.S.C. 24a(g)(3).
94 GLB Act section 103(a); 12 U.S.C. 1843(k)(4)(H) and (I).
95 GLB Act section 121(b)(2). As noted above, this rebuttable presumption applies only if the affiliated financial holding company owns or controls 15 percent or more of the company’s equity capital under the new merchant banking or insurance company investment authorities. The Board notes, however, that under existing Board precedents a bank holding company may not own any shares of a company in reliance on sections 4(c)(6) or 4(c)(7) of the BHC Act where the holding company owns or controls, in the aggregate under a combination of authorities, more than 5 percent of any class of voting securities of the company.
those listed in the Board’s merchant banking regulation.\textsuperscript{96} The first exemption applies where no director, officer, or employee of the holding company serves as a director of the company. The second exemption applies where an independent third party controls a greater percentage of the equity capital of the company than is controlled by the holding company, and no more than one officer or employee of the holding company serves as a director of the company. The third exemption applies where an independent third party controls more than 50 percent of the voting shares of the company, and officers and employees of the holding company do not constitute a majority of the directors of the company.

For purposes of these safe harbors, the rule provides that the term “holding company” includes any subsidiary of the holding company, including any subsidiary depository institution of the holding company. Accordingly, if a directory subsidiary bank or nonbank subsidiary of a financial holding company also serves as a director of a portfolio company, the first safe harbor, for example, would be unavailable. These safe harbors do not require Board review or approval. Moreover, the safe harbors are not intended to be a complete list of circumstances in which the presumption may be rebutted. The regulation also provides, consistent with the GLB Act, that a bank or company may rebut the presumption of affiliation with respect to a company by presenting information to the Board that demonstrates, to the Board’s satisfaction, that the holding company does not control the portfolio company.

A financial holding company generally is considered to own or control only those shares or other ownership interests that are owned or controlled by itself or by a subsidiary of the holding company. The rule clarifies that, for purposes of applying the presumption of affiliation described above, a financial holding company that has an investment in a private equity fund (as defined in the Board’s merchant banking rule) will not be considered indirectly to own the equity capital of a company in which the fund has invested unless the financial holding company controls the private equity fund (as described in the Board’s merchant banking rule).\textsuperscript{97}

4. Certain joint venture companies—223.24(b)(1)(iii). As noted above, under the terms of section 23A, subsidiaries of a bank generally are not treated as affiliates of the bank, even if they would otherwise qualify as affiliates.\textsuperscript{98} The statute contains two specific exceptions to this general rule: financial subsidiaries of a bank and bank subsidiaries of a bank are treated as affiliates of the parent bank. The statute also provides that the Board may determine that other subsidiaries of a bank should be treated as affiliates if covered transactions between the bank and the subsidiary may be affected by the relationship between the companies to the detriment of the bank.\textsuperscript{99}

Pursuant to this authority, the Board proposes to determine that two additional classes of subsidiaries of a bank should be treated as affiliates. First, the proposed regulation provides that any subsidiary of a bank in which an affiliate of the bank directly owns or controls 25 percent or more of any class of voting securities would be considered an affiliate of the bank. For example, a joint venture company that is 50 percent owned by a bank holding company and 50 percent owned by one of its subsidiary banks, would be treated as an affiliate of the bank. In such circumstances, although the joint venture company qualifies as a subsidiary of the bank under section 23A because the bank owns more than 25 percent of the company’s voting stock, the holding company’s substantial direct interest in the company creates the potential for conflicts of interest that may endanger the bank.

This proposed treatment of certain bank-affiliate joint ventures as affiliates does not apply to joint ventures between a bank and affiliated banks or insured savings associations. For example, if two affiliated banks each own 50 percent of the stock of a company, the company would continue to qualify as a subsidiary and not an affiliate of each bank (despite the fact that an affiliate of each bank owns more than 25 percent of a class of voting securities of the company). Such a special rule for joint ventures between a bank and affiliated banks or insured savings associations is consistent with the purpose behind the sister-bank and affiliated-bank exemptions contained in section 23A. The Board does not believe that transactions between a bank and a company that is wholly owned by the bank and its affiliated banks and insured savings associations generally pose material risks to the safety and soundness of the shareholding institutions or to the Federal deposit insurance funds. The Board would retain authority to treat such joint ventures as affiliates under section 23A on a case-by-case basis.

5. Employee benefit plans—223.24(b)(1)(iv). The second proposed regulatory exception to the general rule that subsidiaries of a bank are not treated as affiliates of the bank relates to employee benefit plans. Board staff traditionally has taken the position that most employee stock option plans, trusts, or similar entities that exist to benefit shareholders, members, officers, directors, or employees of a bank or its affiliates (“ESOPs”) should be treated as affiliates of the bank for purposes of sections 23A and 23B. In most cases, the ESOP’s share ownership or the interlocking management between the ESOP and its associated bank or bank holding company exceeds the statutory thresholds for determining that a company is an affiliate. Some institutions have argued, however, that ESOPs should be considered subsidiaries of the bank and therefore exempt from coverage.

The Board believes that the relationship between a bank and its or its affiliates’ ESOP warrants coverage by sections 23A and 23B. In the past, banks have made unsecured loans to such ESOPs or have guaranteed loans to such ESOPs that were made by a third party. These ESOPs, however, generally have no means to repay the loans other than with funds provided by the bank. In addition, the issuance of holding company shares to an ESOP that is funded by a bank loan could be used as a vehicle by the bank to provide funds to its parent holding company when the bank is unable to pay dividends or is otherwise restricted in providing funds to its holding company. Accordingly, the proposed rule provides that a bank or bank affiliate’s ESOP cannot avoid classification as an affiliate of the bank by also qualifying as a subsidiary of the bank.

The Board asks for comment on whether other subsidiaries of a bank should be treated as affiliates of the bank under section 23A.

The Board notes that Regulation W also defines as an affiliate of a bank any partnership for which the bank or any affiliate of the bank serves as a general partner or for which the bank or any affiliate of the bank causes an officer or
employee of the bank or affiliate to serve as a general partner.

B. Definition of Covered Transaction—223.25

The restrictions of section 23A do not apply to every transaction between a bank and its affiliates. The section only applies to “covered transactions” between a bank and its affiliates. The statute defines a covered transaction as (i) an extension of credit to an affiliate; (ii) a purchase of or investment in securities issued by an affiliate; (iii) a purchase of assets from an affiliate; (iv) the acceptance of securities issued by an affiliate as collateral for an extension of credit to any person; and (v) the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate. Among the transactions that generally are not subject to section 23A are dividends paid by a bank to its affiliate, an affiliate underwriting, and many service contracts between a bank and an affiliate. This section discusses several interpretive issues that have arisen in determining whether transactions between a bank and an affiliate are covered transactions for purposes of section 23A.

1. Confirmation of a letter of credit issued by an affiliate. Section 23A(b)(7)(E) includes as a covered transaction the issuance of a letter of credit by a bank on behalf of an affiliate. The proposed regulation clarifies that the confirmation of a letter of credit issued by an affiliate is a covered transaction. When a bank confirms a letter of credit, it assumes the risk of the underlying transaction to the same extent as if it had issued the letter of credit.

2. Credit enhancements supporting a securities underwriting. The Board has confirmed previously that section 23A’s definition of guarantee would not include a bank’s issuance of a guarantee in support of securities issued by a third party and underwritten by a securities affiliate of the bank. Such a credit enhancement would not be issued “on behalf of” the affiliate. In addition, although the guarantee does provide some benefit to the affiliate (by facilitating the underwriting), this benefit is indirect. Accordingly, the proceeds of the guarantee would not be transferred to the affiliate for purposes of the attribution rule of section 23A.

Of course, section 23B would apply to the transaction and, where an affiliate was issuer as well as underwriter, the transaction would be covered by section 23A because the credit enhancement would be on behalf of the affiliate.

3. Cross-guarantee agreements and cross-affiliate netting arrangements. In addition, Board staff has confirmed previously that a cross-guarantee agreement among a bank, an affiliate, and a nonaffiliate in which the nonaffiliate may use the bank’s assets to satisfy the obligations of a defaulting affiliate is a guarantee for purposes of section 23A. The Board believes that such cross-guarantee arrangements among banks and their affiliates should be subject to the quantitative limits and collateral requirements of section 23A.

Similarly, the Board understands that some banks have entered into or are contemplating entering into cross-affiliate netting arrangements. These are arrangements among a bank, one or more affiliates of the bank, and one or more nonaffiliates of the bank, where a nonaffiliate is permitted to net obligations of an affiliate of the bank to the nonaffiliate when settling the nonaffiliate’s obligations to the bank. These arrangements also would include agreements where a bank is required to add the obligations of an affiliate of the bank to a nonaffiliate when determining the bank’s obligations to the nonaffiliate.

Cross-affiliate netting arrangements expose a bank to the credit risk of its affiliates. Under these agreements, a bank may become obligated effectively to make good on the obligations of its affiliates. The exposure of a bank to its affiliates in such an arrangement resembles closely the exposure of a bank when it issues a guarantee on behalf of an affiliate or extends credit to an affiliate. Accordingly, the Board believes that cross-affiliate netting arrangements are credit transactions under section 23A. Accordingly, the quantitative limits of section 23A would prohibit a bank from entering into a cross-affiliate netting arrangement to the extent that the netting arrangement does not cap the potential exposure of the bank to the participating affiliate(s).

The Board asks for comment on whether alternative treatments of cross-guarantees or cross-affiliate netting arrangements under section 23A would be appropriate.

4. Keepwell agreements. Banks have asked for guidance on the question of whether a “keepwell” agreement should be considered a guarantee for purposes of section 23A. In a keepwell agreement between a bank and an affiliate, the bank typically commits to maintain the capital levels or solvency of the affiliate. The credit risk incurred by the bank in entering into such a keepwell agreement is similar to the credit risk incurred by a bank in connection with issuing a guarantee on behalf of an affiliate. Accordingly, keepwell agreements generally should be treated as guarantees for purposes of section 23A and, if unlimited in amount, would be prohibited by the quantitative limits of section 23A.

5. Securitization vehicles. The Board seeks comment on whether additional clarification is necessary in the area of securitizations. In the securitization process, a bank segregates certain of its or its customer’s assets into a relatively homogenous pool and then transfers the pool to a bankruptcy-remote special purpose entity (“SPE”). The SPE, all of whose voting securities are generally held by a party other than the bank or the bank’s customer, then issues securities to investors. The SPE often receive some form of credit enhancement from the bank, the bank’s customer, or a third-party guarantor. The Board requests comment on the question of whether such SPEs should in any circumstances be deemed to be affiliates of the bank involved in the securitization and, if so, what transactions between the bank and the SPE should be considered covered transactions under section 23A.

6. Loans and extensions of credit. Although section 23A includes a “loan or extension of credit” as a covered transaction, the statute does not define these terms. The proposed regulation defines “extension of credit” to mean an extension or renewal of a loan, a grant of a line of credit, or an extension of credit in any manner whatsoever, including on an intraday basis. The regulation also provides a nonexhaustive list of transactions that the Board deems to be extensions of credit, including an advance by means of an overdraft, cash item, or otherwise; a lease that is the functional equivalent of an extension of credit; a purchase of a note or other obligation, including commercial paper or other debt securities; and any increase in the amount of, extension of the maturity of, or adjustment in the interest rate term or other material term of an extension of credit.

A floating-rate loan does not become a new covered transaction whenever there is a change in the relevant index (for example, LIBOR or the bank’s prime rate) from which the loan’s interest rate is calculated. If the bank and the borrower, however, amend the loan agreement to change the index on which the loan rate is calculated, the loan would be a new covered transaction.

103 See Letter dated Aug. 6, 1993, from J. Virgil Mattingly, General Counsel to the Board, to Richard Lasner.

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

As noted, the regulation proposes to clarify that a bank’s purchase of a note or debt security, including commercial paper, issued by an affiliate is a loan or extension of credit by the bank to the affiliate for purposes of section 23A. The Board is aware that some banks have purchased or have proposed to purchase the commercial paper of their holding companies, and have done so or proposed to do so without collateralizing the purchase. These banks have argued that a purchase of commercial paper is a “purchase of or investment in securities issued by an affiliate” for purposes of section 23A, and that such a purchase cannot also then be an “extension of credit” for purposes of section 23A and its collateral requirements.

Although the Board is aware that section 23A’s definition of covered transaction separately includes a bank’s purchase of securities issued by an affiliate and a bank’s extension of credit to an affiliate, the fact that a holder of debt securities expects repayment of principal upon maturity makes debt securities closely resemble loans for purposes of section 23A and the statute’s objective of protecting the bank. Therefore, Regulation W provides that a bank that buys debt securities issued by an affiliate has made an extension of credit to an affiliate under section 23A and must collateralize the transaction in accordance with the section 23A collateral requirements applicable to extensions of credit.

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

The Board asks for comment on whether other aspects of the definition of extension of credit are in need of clarification.

C. Other Definitions—223.26

1. Bank—223.26(c). Regulation W applies to all “banks.” As discussed above, sections 23A and 23B apply by their terms to member banks of the Federal Reserve System, and the Federal Deposit Insurance Act subjects insured nonmember banks to the restrictions of sections 23A and 23B as if they were member banks. Accordingly, the proposed rule defines the term “bank” to include any “member bank,” as defined in section 1 of the Federal Reserve Act, and any “insured branch,” other than an “insured bank,” as such terms are defined in section 3 of the Federal Deposit Insurance Act.

The definition of bank in the regulation also states that most subsidiaries of a bank are to be treated as the bank itself for purposes of sections 23A and 23B. The only subsidiaries of a bank that are excluded from treatment as financial subsidiaries, depository institution subsidiaries, certain joint venture subsidiaries, and ESOPs—companies that are deemed affiliates of the bank under the regulation. This treatment of subsidiaries reflects the fact that the statute typically does not distinguish between a member bank and its subsidiaries, and all of the significant restrictions of the statute apply to actions taken by a member bank “and its subsidiaries.” The Board believes that defining the term “bank” as described above and using the term “bank” wherever the statute says “member bank and its subsidiaries” makes the regulation shorter and easier to understand while also reminding banks that certain subsidiaries of a bank should not be treated as part of the bank for purposes of the statute.

2. Capital stock and surplus—223.26(d). Under section 23A, the quantitative limits on covered transactions are based on the “capital stock and surplus” of the bank. The proposed regulation includes a definition of capital stock and surplus that the Board previously adopted as an interpretation of section 23A. Capital stock and surplus is defined as the sum of the bank’s tier 1 capital and tier 2 capital and the balance of the bank’s allowance for loan and lease losses not included in its tier 2 capital. This definition employs familiar concepts contained in the Federal banking agencies’ capital adequacy guidelines, and is consistent with the loans-to-one-borrower limits applicable to national banks and the Board’s Regulation O, which limits lending to a bank’s insiders. Use of a common definition across these rules should reduce compliance burden. The Board requests comment, however, on whether the balance of a bank’s allowance for loan and lease losses not included in its tier 2 capital should be included in section 23A’s “capital stock and surplus.”

The National Bank Act requires a national bank, “in determining compliance with applicable capital standards,” to deduct from its capital the aggregate amount of any outstanding equity investments, including retained earnings, of the bank in all its financial subsidiaries. The Federal Deposit Insurance Act imposes the same capital deduction requirement on insured state banks that establish financial subsidiaries. In determining compliance with the quantitative limits of section 23A, a bank is required by statute to include in its covered transactions any equity investments (excluding retained earnings) of the bank in its financial subsidiaries. It would be unfair to compel a bank to include such investments in its covered transaction amount (the numerator of the fraction in section 23A’s quantitative limits) but to exclude such investments from capital (the denominator of the fraction).
denominator of the fraction). Accordingly, a bank with a financial subsidiary may add back to its section 23A “capital stock and surplus” the amount of any investment in a financial subsidiary that counts as a covered transaction and is required to be deducted from the bank’s capital for regulatory capital purposes.

3. Control—223.26(f). Section 23A provides that a company or shareholder shall be deemed to have control over another company if, among other things, such company or shareholder controls in any manner the election of a majority of the “directors or trustees” of the other company. Regulation W expands this prong of the control definition to conform it to the control definition contained in the Board’s Regulation Y by adding that control also exists when a company or shareholder controls the election of a majority of the “general partners (or individuals exercising similar functions)” of another company.

In addition, the regulation includes two additional presumptions of control that are similar to presumptions contained in Regulation Y. First, a company will be deemed to control securities, assets, or other ownership interests controlled by any subsidiary of the company. Second, a company that controls securities (including options and warrants) that are convertible, at the option of the holder or owner, into other securities, will be deemed to control the other securities, as long as the holder of such other securities would be deemed to control another company (including a partnership, limited liability company, or other similar organization) if the company or shareholder controlled the election of a majority of the principal policymakers of such other company.

4. Low-quality asset—223.26(q). Two provisions of section 23A restrict a bank’s ability to engage in transactions with affiliates that involve low-quality assets. First, the statute prohibits a bank from purchasing a low-quality asset from an affiliate unless the bank performed an independent credit evaluation and committed itself to purchase the asset prior to the asset’s acquisition by the affiliate. Second, the statute prohibits a bank from counting a low-quality asset toward section 23A’s collateral requirements for a credit transaction with an affiliate.

For purposes of these provisions, section 23A defines a low-quality asset to include (i) an asset classified as “substandard,” “doubtful,” or “loss” or treated as “other loans especially mentioned” in the most recent report of examination or inspection by a Federal or State supervisory agency (a “classified asset”); (ii) an asset in nonaccrual status; (iii) an asset on which payments are more than thirty days past due; or (iv) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.

The Board notes that any asset meeting one of the above four criteria, including securities and real property, is a low-quality asset. The regulation broadens the definition of low-quality asset in three ways. First, the regulation provides that an asset identified by examiners as an “other transfer risk problem” (“OTRP”) is a low-quality asset. Such assets represent credits to countries that are not complying with their external debt-service obligations, but are taking positive steps to restore debt service through economic adjustment measures, generally as part of an International Monetary Fund program. Although OTRP assets are not considered classified assets, examiners are instructed to consider such assets in their assessment of a bank’s asset quality and capital adequacy. The Board asks for comment on the appropriateness of treating OTRP assets as low-quality assets under section 23A.

Second, the regulation reflects the increasing use by financial institutions of their own internal asset classification systems. A recent Board study of the 50 largest U.S. banks demonstrated that all use internal loan classifications, and a substantial proportion of such institutions have relatively advanced internal rating systems. Although there is considerable variance in how large banks rate performing assets, the banks generally use the same categories employed by the Federal banking agencies for rating classified assets. Because examinations may be twelve months apart—eighteen months for smaller banks—these internal classification systems may cause a bank to regrade an asset long before its next examination. Accordingly, the Board is proposing to include within the definition of low-quality asset not only assets classified during the last examination but also assets classified by the affiliate’s internal classification system (or assets that received an internal rating that is substantially equivalent to classified in such an internal system). These assets generally have been renegotiated or compromised because the borrower is in financial distress and, thus, typically would meet the fourth prong of the statutory definition of low-quality asset. Moreover, the purchase of such assets by a bank raises safety and soundness concerns.

The Board has some concern that this interpretation may induce companies to avoid or defer reclassification of an asset in order to allow its sale to an affiliated bank, but believes that such evasions can be addressed through the examination process. The Board expects companies with internal rating systems to use the systems consistently over time and over similar classes of assets and will view as an evasion of section 23A any company’s deferral or alteration of an asset’s rating to facilitate sale of the asset to an affiliated bank.

Finally, the proposed rule defines low-quality asset to include foreclosed property designated “other real estate owned,” until it is reviewed by an examiner and receives a favorable classification. In the Board’s experience, such property is often of such poor quality that its ownership poses the same risk to the bank as a low-quality loan that was purchased or taken as collateral.

5. Securities—223.26(w). Section 23A defines “securities” to mean “stocks, bonds, debentures, notes, or other similar obligations.” In light of the ambiguous nature of this definition, the Board generally has looked to the securities laws for guidance in determining which financial instruments should be considered securities for purposes of section 23A. In light of the similarities between commercial paper and debentures and notes and the countervailing fact that the Securities Exchange Act of 1934 excludes some forms of commercial securities.
paper from its definition of security.\textsuperscript{125} The proposed regulation clarifies that commercial paper is a security for purposes of section 23A. Accordingly, as discussed in more detail above, when a bank purchases commercial paper issued by an affiliate, the bank makes an extension of credit to the affiliate (which must be secured in accordance with section 23A’s collateral requirements) and purchases securities issued by the affiliate for purposes of section 23A.

6. Voting securities—223.26(aa). Section 23A uses both the terms “voting shares” and “voting securities.” To remove any ambiguity and to provide additional guidance to banks, the proposed regulation replaces all statutory uses of the term “voting shares” with the term “voting securities” and defines “voting securities” to have the same meaning as “voting securities” in Regulation Y.\textsuperscript{126}

Regulatory Flexibility Act

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603(a)), the Board must publish an initial regulatory flexibility analysis with this rulemaking. Sections 23A and 23B of the Federal Reserve Act limit transactions between a bank and its affiliates and authorize the Board to issue regulations as may be necessary to administer and carry out the purposes of the sections. The proposed rule would comprehensively implement these sections of the Federal Reserve Act. The rule would simplify for banks the task of complying with the sections and would help ensure that the sections are consistently interpreted and applied by the Federal banking agencies and the banking industry. A description of the reasons why action by the Board is being considered and a statement of the objectives of, and legal basis for, the proposed rule are contained in the supplementary material provided above.

The proposed rule would apply to all banks regardless of their size. Although the rule potentially affects all banks, the proposed rule would impose on banks. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 \textit{et seq.}), the Board has reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget. No collections of information pursuant to the Paperwork Reduction Act are contained in the proposed rule.

Solicitation of Comments Regarding Use of “Plain Language”

Section 722 of the GLB Act requires the Board to use “plain language” in all proposed and final rules published after January 1, 2000. The Board invites comments about how to make the proposed rule easier to understand, including answers to the following questions:

(1) Has the Board organized the material in an effective manner? If not, how could the material be better organized?

(2) Are the terms of the rule clearly stated? If not, how could the terms be more clearly stated?

(3) Does the rule contain technical language or jargon that is unclear? If so, which language requires clarification?

(4) Would a different format (with respect to grouping and order of sections and use of headings) make the rule easier to understand? If so, what changes to the format would make the rule easier to understand?

(5) Would increasing the number of sections (and making each section shorter) clarify the rule? If so, which portions of the rule should be changed in this respect?

(6) What additional changes would make the rule easier to understand?

List of Subjects in 12 CFR Part 223

Banks, Banking, Federal Reserve System.

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

\begin{table}
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\begin{tabular}{|l|}
\hline
\textbf{PART 223—TRANSACTIONS BETWEEN BANKS AND THEIR AFFILIATES (REGULATION W)}
\hline
\textbf{Subpart A Introduction}
Sec. 223.1 Authority, purpose, and scope.

\textbf{Subpart B—General Provisions of Section 23A}

223.2 What is the maximum amount of covered transactions that a bank may enter into with any single affiliate?

223.3 What is the maximum amount of covered transactions that a bank may enter into with all affiliates?

223.4 What safety and soundness requirement applies to covered transactions?

223.5 What are the collateral requirements for a credit transaction with an affiliate?

223.6 May a bank purchase a low-quality asset from an affiliate?

223.7 What transactions by a bank with any person are treated as transactions with an affiliate?

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\end{tabular}
\end{table}


\textsuperscript{126} See 12 CFR 225.2(q).

Subpart C—Valuation and Timing Principles Under Section 23A

223.8 What valuation and timing principles apply to credit transactions?

223.9 What valuation and timing principles apply to asset purchases?

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

223.11 What valuation principles apply to extensions of credit secured by affiliate securities?

Subpart D—Other Considerations Under Section 23A

223.12 How does section 23A apply to a bank’s acquisition of an affiliate that becomes a subsidiary of the bank after the acquisition?

223.13 What rules apply to financial subsidiaries of a bank?

223.14 What rules apply to derivative contracts? [Reserved]

Subpart E—Exemptions From the Provisions of Section 23A

223.15 What covered transactions between a bank and an insured depository institution are exempt from the quantitative limits and collateral requirements?

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

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

Subpart F—General Provisions of Section 23B

223.18 What is the market terms requirement of section 23B?

223.19 What transactions with affiliates or others must comply with section 23B’s market terms requirement?

223.20 What asset purchases are prohibited by section 23B?

223.21 What advertisements and statements are prohibited by section 23B?

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

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

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

Subpart H—Definitions of Terms

223.24 What is an “affiliate” for purposes of sections 23A and 23B?

223.25 What transactions with affiliates are covered by section 23A?

223.26 What are the meanings of the other terms used in sections 23A and 23B?

Authority: 12 U.S.C. 371c(b)(1) (E) and (f), 371c–1(e), 1828(j), 1468.
Subpart A—Introduction

§ 223.1 Authority, purpose, and scope.

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

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

(c) Scope. Sections 23A and 23B apply by their terms to “member banks”—that is, national banks, State banks, trust companies, and other institutions that are members of the Federal Reserve System. The Federal Deposit Insurance Act (12 U.S.C. 1828(j)) subjects insured nonmember banks to sections 23A and 23B as if they were member banks. Accordingly, this regulation applies to member banks and insured nonmember banks, and uses the term “banks” to describe the companies that are subject to its provisions. This regulation implements sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c, 371c–1); it does not contain every statutory or regulatory restriction on transactions between banks and their affiliates, including those that may apply to banks subject to prompt corrective action under section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o).

Subpart B—General Provisions of Section 23A

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

A bank may not engage in a covered transaction with an affiliate if the aggregate amount of the bank’s covered transactions with any affiliate would exceed 10 percent of the capital stock and surplus of the bank.

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

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

§ 223.4 What safety and soundness requirements apply to covered transactions?

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

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

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

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

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

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

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

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

(4) A segregated, earmarked deposit account with the bank that is for the sole purpose of securing the transaction and is so identified;

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

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

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

(c) Ineligible collateral. The following items are not eligible collateral for purposes of this section:

(1) Low-quality assets;

(2) Securities issued by any affiliate or the bank;

(3) Intangible assets, including servicing assets; and

(4) Guarantees and letters of credit.

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

(2) A bank either must obtain a first priority security interest in collateral required by this section or must deduct from the value of collateral obtained by the bank the lesser of:

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

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

(e) Replacement requirement for retired or amortized collateral. A bank must replace any required collateral that subsequently is retired or amortized with additional eligible collateral as needed to keep the percentage of the outstanding credit transaction equal to the minimum percentage required at the inception of the transaction.

(f) Inapplicability of the collateral requirements to certain acceptances. The collateral requirements of this section do not apply to an acceptance that already is fully secured either by attached documents or by other property that is involved in the transaction and has an ascertainable market value.

(g) Inapplicability of the collateral requirements to the undrawn portion of certain extensions of credit. The collateral requirements of this section do not apply to the undrawn portion of an extension of credit to an affiliate so long as the bank does not have any legal obligation to advance additional funds under the extension of credit until the affiliate posts the amount of collateral required by paragraph (b) of this section with respect to the entire drawn portion of the extension of credit.

§ 223.6 May a bank purchase a low-quality asset from an affiliate?

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

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

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

(2) The renewal or extension of additional credit is approved by the board of directors of the participating bank as necessary to protect the bank’s
investment by enhancing the ultimate
collection of the original indebtedness;
(3) The participating bank’s share of
the renewal or additional extension of
credit does not exceed its proportional
share of the original transaction; and
(4) The participating bank provides its
appropriate Federal banking agency
with 20 days’ prior notice of the
proposed renewal or additional
extension of credit.

§ 223.7 What transactions by a bank with
any person are treated as transactions with
an affiliate?

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

(b) Exemptions. Notwithstanding
paragraph (a) of this section, the
following transactions are not subject to the
quantitative limits of §§ 223.2 and
223.3 or the collateral requirements of
§ 223.5. The transactions are, however,
subject to the safety and soundness
requirement of § 223.4, the prohibition
on the purchase of a low-quality asset of
§ 223.6, and the market terms
requirement and other provisions of
subpart F of this part.

(1) Certain riskless principal
transactions. An extension of credit by
a bank to a nonaffiliate, if:
(i) The proceeds of the extension of
credit are used to purchase a security
through a securities affiliate of the bank,
and the securities affiliate is acting
exclusively as a riskless principal for
the nonaffiliate in the transaction;
(ii) The security purchased by the
nonaffiliate is not issued or
underwritten by, or sold out of the
inventory of, any affiliate of the bank;
and
(iii) Any riskless principal mark-up or
other compensation received by the
affiliate from the proceeds of the
extension of credit meets the market
terms standard set forth in paragraph
(b)(2) of this section.

(2) Brokerage commissions, agency
fees, and riskless principal mark-ups.
An affiliate’s retention of a portion of the
proceeds of an extension of credit
described in paragraph (b)(1) of this
section or in 12 CFR 250.243 as a
brokerage commission, agency fee, or
riskless principal mark-up, if that
commission, fee, or mark-up is
substantially the same as, or lower than,
those prevailing at the same time for
comparable transactions with or
involving other nonaffiliates, in
accordance with the market terms
requirement of § 223.18.

(3) Preexisting lines of credit. An
extension of credit by a bank to a
nonaffiliate, if:
(i) The proceeds of the extension of
credit are used to purchase a security
from or through a securities affiliate of
the bank; and
(ii) The extension of credit is made
pursuant to, and consistent with any
conditions imposed in, a preexisting
line of credit that was not established in
contemplation of the purchase of
securities from or through an affiliate of
the bank.

(4) General purpose credit card
transactions. An extension of credit by
a bank to a nonaffiliate, if:
(i) The proceeds of the extension of
credit are used by the nonaffiliate to
purchase a product or service from an
affiliate of the bank; and
(ii) The extension of credit is made
pursuant to, and consistent with any
conditions imposed in, a general
purpose credit card issued by the bank
to the nonaffiliate.

Subpart C—Valuation and Timing
Principles under Section 23A

§ 223.8 What valuation and timing
principles apply to credit transactions?

(a) Valuation. (1) Initial valuation of
direct credit transactions. Except as
provided in paragraph (a)(2) or (3) of
this section, a credit transaction with an
affiliate initially must be valued at the
sum of:
(i) The amount provided to, or on
behalf of, the affiliate in the transaction;
and
(ii) Any additional amount that the
bank could be required to provide to, or
on behalf of, the affiliate under the
terms of the transaction.

(2) Initial valuation of indirect credit
transactions. If a bank acquires a credit
transaction with an affiliate, the covered
transaction initially must be valued at the
sum of:
(i) The total amount of consideration
given (including liabilities assumed) by
the bank in exchange for the credit
transaction; and
(ii) Any additional amount that the
bank could be required to provide to, or
on behalf of, the affiliate under the
terms of the transaction.

(b) Timing. (1) In general. A bank
engages in a credit transaction with an
affiliate:
(i) At the time during the day that the
bank becomes legally obligated to make
an extension of credit to, issue a
guarantee, acceptance, or letter of credit
on behalf of, or confirm a letter of credit
issued by, an affiliate; and
(ii) At the time during the day that the
bank acquires an extension of credit to,
or guarantee, acceptance, or letter of
credit issued on behalf of, an affiliate.

(2) Credit transactions by a bank with
a nonaffiliate that becomes an affiliate
of the bank. (i) In general. A credit
transaction with a nonaffiliate becomes
a covered transaction at the time that
the nonaffiliate becomes an affiliate of
the bank. The bank must ensure that any
such credit transaction complies with
the collateral requirements of § 223.5
promptly after the nonaffiliate becomes
an affiliate. The bank also must treat the
amount of any such credit transaction as
part of the aggregate amount of the
bank’s covered transactions for purposes
of determining compliance with the
quantitative limits of §§ 223.2 and 223.3
in connection with any future covered
transactions. Except as described in
paragraph (b)(2)(iii) of this section, the
bank is not required to reduce the
amount of its covered transactions with
any affiliate because the nonaffiliate has
become an affiliate.

(ii) Credit transactions by a bank with
a nonaffiliate in contemplation of the
nonaffiliate becoming an affiliate of the
bank. In addition to the provisions of
paragraph (b)(2)(i) of this section, if a
bank engages in a credit transaction
with a nonaffiliate in contemplation of
the nonaffiliate becoming an affiliate of
the bank, the bank must ensure that the
aggregate amount of the bank’s covered
transactions (including any such
transaction with the nonaffiliate) would
not exceed the quantitative limits of
§§ 223.2 or 223.3 at the time the
nonaffiliate becomes an affiliate.

(iii) Example. A bank with capital
stock and surplus of $1,000 and no
outstanding covered transactions makes
a $120 unsecured loan to a nonaffiliate.
Several years later, the bank’s holding
company purchases all the stock of the
nonaffiliate, thereby making the
nonaffiliate an affiliate of the bank. The
bank must ensure that the loan is in compliance with the
collateral requirements of section 23A of the
Federal Reserve Act (12 U.S.C.
371c). The bank will not be in violation of the
quantitative limits of section 23A at the time of the stock
acquisition (unless the loan was made by the bank
in contemplation of the nonaffiliate
becoming an affiliate). The bank will,
however, be prohibited from engaging in
any additional covered transactions
until such time as the value of the loan
transaction falls below 10 percent of the bank’s capital stock and surplus.

§ 223.9 What valuation and timing principles apply to asset purchases?

(a) Valuation. (1) In general. Unless the transaction is described in § 223.12, a purchase of an asset (other than a security issued by an affiliate or a note or obligation of an affiliate) by a bank from an affiliate must be valued initially at the total amount of consideration given (including liabilities assumed) by the bank in exchange for the asset. The value of the covered transaction after the purchase may be reduced to reflect amortization or depreciation of the asset, to the extent that such reductions are consistent with GAAP.

(2) Examples of the valuation of asset purchases. The following are examples of how to value a bank’s purchase of an asset from an affiliate.

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

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

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

(2) Asset purchases by a bank from a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the bank. If a bank purchases assets from a nonaffiliate in contemplation of the nonaffiliate becoming an affiliate of the bank, the asset purchase becomes a covered transaction at the time that the nonaffiliate becomes an affiliate of the bank. In addition, the bank must ensure that the aggregate amount of the bank’s covered transactions (including any such transaction with the nonaffiliate) would not exceed the quantitative limits of §§ 223.2 or 223.3 at the time the nonaffiliate becomes an affiliate.

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

(a) Valuation. (1) In general. Except as provided in paragraph (b) of § 223.13 with respect to securities issued by a financial subsidiary, a bank’s purchase of or investment in a security issued by an affiliate must be valued at the greater of:

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

(ii) The carrying value of the security on the financial statements of the bank, determined in accordance with GAAP.

(2) Examples of the valuation of purchases of and investments in the securities of an affiliate (other than a financial subsidiary). The following are examples of how to value a bank’s purchase of or investment in securities issued by an affiliate (other than a financial subsidiary). Examples of how to value a bank’s purchase of or investment in securities issued by a financial subsidiary are provided in paragraph (b)(3) of § 223.13.

(i) Purchase of the debt securities of an affiliate that is not a financial subsidiary. The parent holding company of a bank owns 100 percent of the shares of a mortgage company. The bank purchases debt securities issued by the mortgage company for $600. The initial carrying value of the securities on the bank’s GAAP financial statements is $600. The bank initially must value the investment at $600.

(ii) Purchase of the shares of an affiliate that is not a financial subsidiary. The parent holding company of a bank owns 51 percent of the shares of a mortgage company. The bank purchases an additional 30 percent of the shares of the mortgage company from a third party for $100. The initial carrying value of the shares on the bank’s GAAP financial statements is $100. The bank initially must value the investment at $100. Going forward, if the bank’s carrying value of the shares declines to $40, the bank must continue to value the investment at $100.

(iii) Contribution of the shares of an affiliate that is not a financial subsidiary. The parent holding company of a bank owns 100 percent of the shares of a mortgage company and contributes 30 percent of the shares to the bank. The bank gives no consideration in exchange for the shares. If the initial carrying value of the shares on the bank’s GAAP financial statements is $300, then the bank initially must value the investment at $300. Going forward, if the bank’s carrying value of the shares increases to $500, the bank must value the investment at $500.

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

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

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

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

(2) The fair market value of the affiliate’s securities that are pledged as collateral, if such securities meet the market quotation standard contained in paragraph (e)(1) of § 223.16 or the standards set forth in paragraphs (e)(2)(i) and (v) of § 223.16.

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

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

(2) The fair market value of the affiliate’s securities that are pledged as collateral, if such securities meet the market quotation standard contained in paragraph (e)(1) of § 223.16 or the standards set forth in paragraphs (e)(2)(i) and (v) of § 223.16.

Subpart D—Other Considerations Under Section 23A

§ 223.12 How does section 23A apply to a bank’s acquisition of an affiliate that becomes a subsidiary of the bank after the acquisition?

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

(1) As a result of the transaction, the company becomes a subsidiary of the bank and ceases to be an affiliate of the bank; and

(2) The company has liabilities, or the bank gives cash or any other consideration in exchange for the security.
(b) Valuation. A transaction described in paragraph (a) of this section but not exempt under paragraph (d) of this section must be valued initially at the sum of:

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

(2) The total liabilities of the company whose securities have been acquired by the bank, as of the time of the acquisition.

c) Valuation example. The parent holding company of a bank contributes between 25 and 100 percent of the voting shares of a mortgage company to the bank. The bank gives no consideration in exchange for the shares. The mortgage company has total assets of $300,000 and total liabilities of $100,000. As a result of the transaction, the mortgage company becomes a subsidiary of the bank and ceases to be an affiliate of the bank. The transaction is treated as a purchase of the assets of the mortgage company by the bank from an affiliate under paragraph (a) of this section. The bank initially must value the transaction at $100,000, the total amount of the liabilities of the mortgage company.

d) Exemption for step transactions. A transaction described in paragraph (a) of this section is not subject to the provisions of subpart B of this part (other than the safety and soundness requirement of §223.4) if:

(1) The bank acquires the securities issued by the company immediately after the company becomes an affiliate of the bank;

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

(3) The acquisition complies with the market terms requirement of §223.18.

§223.13 What rules apply to financial subsidiaries of a bank?

(a) Exemption from the 10 percent limit for covered transactions between a bank and a single financial subsidiary. The 10 percent quantitative limit contained in §223.2 does not apply with respect to covered transactions between a bank and a financial subsidiary of the bank. The 20 percent quantitative limit contained in §223.3 does apply to such transactions.

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

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

(ii) The carrying value of the security on the financial statements of the bank, determined in accordance with GAAP but without reflecting the bank’s pro rata portion of any earnings retained or losses incurred by the financial subsidiary after the bank’s acquisition of the security.

(2) Carrying value of an investment in a consolidated financial subsidiary. If a financial subsidiary is consolidated with its parent bank under GAAP, the carrying value of the bank’s investment in securities issued by the financial subsidiary shall be equal to the carrying value of the securities on parent-only financial statements of the bank, determined in accordance with GAAP but without reflecting the bank’s pro rata portion of any earnings retained or losses incurred by the financial subsidiary after the bank’s acquisition of the securities.

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

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

(B) Contribution of a financial subsidiary to a bank. The parent holding company of a bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500, and immediately contributes the shares to the bank. The bank gives no consideration in exchange for the shares. The bank initially must value the investment at the carrying value of the shares on the bank’s parent-only GAAP financial statements. If the parent holding company’s acquisition of the securities underwriter was accounted for as a purchase, the bank’s initial carrying value of the shares would be $500. Alternatively, if the parent holding company’s acquisition of the securities underwriter was accounted for as a pooling-of-interests, the bank’s initial carrying value of the shares would equal the book value of the underwriter prior to the acquisition, which may be less than $500.

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

(c) Treatment of an affiliate’s investments in, and extensions of credit to, a financial subsidiary of a bank. (1) Investments. Any purchase of, or investment in, the securities of a financial subsidiary of a bank by an affiliate of the bank (other than an affiliate that is itself a bank or an insured savings association) will be treated as a purchase of or investment in such securities by the bank.

(2) Extensions of credit. Any extension of credit to a financial subsidiary of a bank by an affiliate of the bank (other than an affiliate that is itself a bank or an insured savings association) will be treated as an extension of credit by the bank to the financial subsidiary, if the Board determines, by regulation or order, that such treatment is necessary or appropriate to prevent evasions of the Federal Reserve Act or the Gramm-Leach-Bliley Act.

(3) An extension of credit that is treated as regulatory capital of the financial subsidiary. The Board has determined, under the authority of paragraph (c)(2) of this section, that any extension of credit to a financial subsidiary of a bank by an affiliate of the bank (other than an affiliate that is itself a bank or an insured savings association) will be treated as an extension of credit by the bank to the financial subsidiary if the extension of credit is treated as capital of the financial subsidiary under any Federal or State law, regulation, or interpretation applicable to the subsidiary.
§ 223.14 What rules apply to derivative contracts? [Reserved]

Subpart E—Exemptions From the Provisions of Section 23A

§ 223.15 What covered transactions between a bank and an insured depository institution are exempt from the quantitative limits and collateral requirements?

The following transactions are not subject to the quantitative limits of §§ 223.2 and 223.3 or the collateral requirements of § 223.5. The transactions are, however, subject to the safety and soundness requirement of § 223.4 and the prohibition on the purchase of a low-quality asset of § 223.6.

(a) Parent institution/subsidiary institution transactions. Transactions with an insured depository institution if the bank controls 80 percent or more of the voting securities of the insured depository institution or the insured depository institution controls 80 percent or more of the voting securities of the bank;

(b) Transactions between a bank and an insured depository institution owned by the same holding company. Transactions with an insured depository institution if the same company controls 80 percent or more of the voting securities of the bank and the insured depository institution; and

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

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

The following transactions are not subject to the quantitative limits of §§ 223.2 and 223.3, the collateral requirements of § 223.5, or the prohibition on the purchase of a low-quality asset of § 223.6. The transactions are, however, subject to the safety and soundness requirement of § 223.4.

(a) Making correspondent banking deposits. Making a deposit in an affiliated depository institution or affiliated foreign bank that represents an ongoing, working balance maintained in the ordinary course of correspondent business;

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

(c) Transactions secured by cash or U.S. government securities. Engaging in a credit transaction with an affiliate that is fully secured by:

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

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

(3) A segregated, earmarked deposit account with the bank that is for the sole purpose of securing the credit transaction and is identified as such;

(d) Purchasing securities of a servicing affiliate. Purchasing a security issued by any company engaged solely in providing services described in section 4(c)(1) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)(1));

(e) Purchasing certain liquid assets.

(1) Purchasing an asset (other than a security issued by an affiliate) having a readily identifiable and publicly available market quotation and purchased at or below the asset’s current market quotation. An asset has a readily identifiable and publicly available market quotation if:

(i) The asset’s price paid by the bank is at or below the current market quotation,

(ii) The asset is an obligation of the United States or its agencies or an obligation fully guaranteed by the United States or its agencies as to principal and interest; or

(2) Purchasing a security from a securities affiliate, if:

(i) The security has a “ready market,” as defined in 17 CFR 240.15c3–1(c)(11)(i);

(ii) The security is eligible for a State member bank to purchase directly, subject to the same terms and conditions that govern the investment activities of a State member bank, and the bank records the transaction as a purchase of a security for purposes of the bank Call Report, consistent with the requirements for a State member bank; and

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

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

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

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

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

(vi) The security is not issued by an affiliate, unless the security is an obligation fully guaranteed by the United States or its agencies as to principal and interest.

(f) Purchasing municipal securities. Purchasing a municipal security from a securities affiliate if:

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

(2) The security is eligible for purchase by a State member bank, subject to the same terms and conditions that govern the investment activities of a State member bank, and the bank records the transaction as a purchase of a security for purposes of the bank Call Report, consistent with the requirements for a State member bank; and

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

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

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

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

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

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

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

(A) Purchases the municipal security during the underwriting period;

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

(C) Purchases the municipal security at a price that is at or below that indicated in the summary;

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

(h) Asset purchases by a de novo bank. The purchase of an asset from an affiliate by a de novo bank, if the appropriate Federal banking agency for the bank has approved the asset purchase in writing in connection with its review of the formation of the bank;

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

(j) Purchasing an extension of credit from an affiliate. Purchasing an extension of credit from an affiliate, if:

(1) The bank makes an independent evaluation of the creditworthiness of the borrower prior to the affiliate making or committing to make the extension of credit;

(2) The bank commits to purchase the extension of credit prior to the affiliate making or committing to make the extension of credit;

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

(4) The dollar amount of the bank’s total accumulated purchases from the affiliate, when aggregated with all other assets purchased from the affiliate by banks and insured savings associations that are affiliates of the bank, does not represent more than 50 percent of the dollar amount of extensions of credit originated by the affiliate; and

(5) The bank and its affiliated banks and insured savings associations do not provide substantial, ongoing funding to the affiliate through this exemption.

(k) Certain intraday extensions of credit. (1) In general. An intraday extension of credit that arises in connection with the performance by a bank, in the ordinary course of business, of securities clearing and settlement transactions or payment transactions on behalf of an affiliate and effected through one or more accounts that the affiliate holds with the bank, if the bank:

(i) Has no reason to believe that the affiliate will have difficulty repaying the extension of credit in the ordinary course of business;

(ii) Establishes and maintains prudent limits on the aggregate amount of intraday credit that the bank may extend to each affiliate, and all affiliates in the aggregate, and integrates these limits into the bank’s overall credit risk exposure limits and systems;

(iii) Establishes and maintains policies, procedures, and systems reasonably designed to:

(A) Assess the credit quality of each affiliate that obtains an intraday extension of credit from the bank and determine each such affiliate’s ability to repay such credit extensions;

(B) Periodically monitor each such affiliate’s compliance with the established limits during the business day;

(C) Review an affiliate’s intraday extensions of credit in the event of the affiliate’s violation of the established limits; and

(D) Ensure that any intraday extension of credit received by an affiliate complies with the market terms requirement of §223.18;

(iv) Maintains records and supporting information that are sufficient to enable the appropriate Federal banking agency to review the position limits and the policies, procedures, and systems described in paragraph (k)(1)(iii) of this section; and

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

(2) Definition of “payment transactions”. For purposes of this paragraph (k), “payment transactions” means transactions undertaken for the purpose of transferring funds to another account of the affiliate or to a third party and includes funds transfers, ACH transactions, check transactions, and other similar transactions.

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

(a) The standards. The Board may, at its discretion, by regulation or order, exempt transactions or relationships from the requirements of section 23A of the Federal Reserve Act (12 U.S.C. 371c) and subpart B of this Regulation W if it finds such exemptions to be in the public interest and consistent with the purposes of section 23A.

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

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

A bank may not engage in a transaction described in §223.19 unless the transaction is:

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

(b) In the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliates.

§223.19 What transactions with affiliates or others must comply with section 23B’s market terms requirement?

(a) The market terms requirement of §223.18 applies to the following transactions:

(1) Any covered transaction with an affiliate, unless the transaction is:

(i) Exempt under §223.15 or paragraphs (a) through (e)(1) or (g) through (i) of §223.16; and

(ii) Consistent with the safety and soundness requirement of §223.4;

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

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

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

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

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

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

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

§223.20 What asset purchases are prohibited by section 23B?

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

(1) Under the instrument creating the fiduciary relationship;

(2) By court order; or

(3) Under section 23B.
§ 223.21 What advertisements and statements are prohibited by section 23B?

(a) In general. A bank and its affiliates may not publish any advertisement or enter into any agreement stating or suggesting that the bank will in any way be responsible for the obligations of its affiliates.

(b) Guarantees, acceptances, and letters of credit subject to section 23A. Paragraph (a) of this section does not prohibit a bank from issuing a guarantee, acceptance, or letter of credit on behalf of an affiliate to the extent otherwise permitted under this Regulation W.

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

The Board may prescribe regulations to exempt transactions or relationships from the requirements of section 23B of the Federal Reserve Act (12 U.S.C. 371c–1) and subpart F of this Regulation W if it finds such exemptions to be in the public interest and consistent with the purposes of section 23B.

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

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

(a) Applicability of sections 23A and 23B to foreign banks engaged in underwriting insurance, underwriting or dealing in securities, merchant banking, or insurance company investment in the United States. Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c–1) and the provisions of this Regulation W apply to transactions between each U.S. branch, agency, or commercial lending company of a foreign bank and any person to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, a company described in paragraphs (a)(1) through (3) of this section.

(1) Any affiliate of the foreign bank directly engaged in the United States in any of the following activities:

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

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

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

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

(b) Method of applying sections 23A and 23B to foreign banks. (1) In general. Sections 23A and 23B of the Federal Reserve Act and the provisions of this Regulation W will apply to transactions described in paragraphs (a) of this section in the same manner and to the same extent as if the branch, agency, or commercial lending company of the foreign bank were a bank and the companies described in paragraphs (a)(1) through (3) of this section were affiliates of the branch, agency, or commercial lending company.

(2) Attribution rule. Sections 23A and 23B of the Federal Reserve Act and the provisions of this Regulation W will apply to transactions between each U.S. branch, agency, or commercial lending company of a foreign bank and any person to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, a company described in paragraphs (a)(1) through (3) of this section.

(3) Capital stock and surplus. For purposes of §§ 223.2 and 223.3, the “capital stock and surplus” of a U.S. branch, agency, or commercial lending company of a foreign bank will be determined by reference to the capital of the foreign bank as calculated under its home country capital standards.

Subpart H—Definitions of Terms

§ 223.24 What is an “affiliate” for purposes of sections 23A and 23B?

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

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

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

(3) Companies under other common ownership. Any company, including any subsidiary of the bank, that is controlled, directly or indirectly, by trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the bank or any company that controls the bank;
(4) Companies with interlocking directorates. Any company in which a majority of its directors or trustees (or individuals exercising similar functions) constitute a majority of the persons holding any such office with the bank or any company that controls the bank;

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

(6) Investment companies. (i) Any investment company for which the bank or any affiliate of the bank serves as an investment adviser, as defined in section 2(a)(20) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(20)); and (ii) Any other investment fund for which the bank or any affiliate of the bank serves as an investment advisor, if the bank or any affiliate of the bank owns or controls more than 5 percent of any class of voting shares or similar interests in the fund;

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

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

(9) Companies held under merchant banking or insurance company investment authority. (i) In general. Any company in which a holding company that controls the bank (or a holding company that is controlled by shareholders that control the bank) owns or controls, directly or indirectly, or acting through one or more other persons, 15 percent or more of the equity capital pursuant to section 4(k)(4)[H] or (I) of the Bank Holding Company Act (12 U.S.C. 1843[k][4][H] or (I)). (ii) General exemption. A company may avoid affiliate status under paragraph (a)(9)(i) of this section if the holding company presents information to the Board that demonstrates, to the Board’s satisfaction, that the holding company does not control the company.

(iii) Specific exemptions. A company may also avoid affiliate status under paragraph (a)(9)(i) of this section if: (A) No director, officer, or employee of the holding company serves as a director, trustee, or general partner (or individual exercising similar functions) of the company; (B) A person that is not affiliated or associated with the holding company owns or controls a greater percentage of the equity capital of the company than is owned or controlled by the holding company, and no more than one officer or employee of the holding company serves as a director or trustee (or individual exercising similar functions) of the company; or (C) A person that is not affiliated or associated with the holding company owns or controls more than 50 percent of the voting shares of the company, and officers and employees of the holding company do not constitute a majority of the directors or trustees (or individuals exercising similar functions) of the company.

(iv) Application of rule to private equity funds. A holding company will not be deemed to own or control the equity capital of a company for purposes of paragraph (a)(9)(i) of this section solely by virtue of an investment made by the holding company in a private equity fund (as defined in 12 CFR 225.173[a]) that owns or controls as the equity capital of the company unless the holding company controls the private equity fund (as described in 12 CFR 225.173(d)[4]).

(v) Definition of “holding company”: For purposes of this paragraph (a)(9), “holding company” means the holding company and all of its subsidiaries (including any subsidiary depository institution of the holding company);

(10) Partnerships for which the bank or an affiliate serves as general partner. Any partnership for which the bank or any affiliate of the bank serves as a general partner or for which the bank or any affiliate of the bank causes any officer or employee of the bank or affiliate to serve as a general partner;

and

(11) Other companies. Any company that the Board determines by regulation or order to have a relationship with the bank, or any affiliate of the bank, such that covered transactions by the bank with that company may be affected by the relationship to the detriment of the bank.

(b) “Affiliate” with respect to a bank does not include:

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

(i) A depository institution;

(ii) A financial subsidiary;

(iii) A subsidiary in which any affiliate or affiliates of the bank (other than a bank or insured savings association) directly owns or controls 25 percent or more of any class of voting securities;

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

(v) Any other company determined to be an affiliate under paragraph (a)(11) of this section;

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

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

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

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

(c) For purposes of subpart F of this part, “affiliate” with respect to a bank also does not include any insured depository institution.

§ 223.25 What transactions with affiliates are covered by section 23A?

For purposes of this part, a “covered transaction” with respect to an affiliate of a bank means:

(a) An extension of credit to the affiliate;

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

(c) A purchase of an asset from the affiliate, including an asset subject to recourse or an agreement to repurchase, except such purchases of real and personal property as may be specifically exempted by the Board by order or regulation;

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

(e) The issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of the affiliate, and a confirmation of a letter of credit issued by the affiliate.

§ 223.26 What are the meanings of the other terms used in sections 23A and 23B?

For purposes of this part:

(a) Aggregate amount of covered transactions means the amount of the covered transaction about to be engaged in added to the current amount of all outstanding covered transactions.
(b) Appropriate Federal banking agency has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

(c) Bank. (1) In general. Bank means:
(i) Any member bank, as defined in section 1 of the Federal Reserve Act (12 U.S.C. 221); and
(ii) Any insured bank that is not an insured branch, as such terms are defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

(2) Subsidiaries of banks. For purposes of paragraph (c)(1) of this section, a subsidiary of a bank (other than a subsidiary described in paragraphs (b)(1)(i) through (v) of § 223.24) is treated as the bank.

(d) Capital stock and surplus means the sum of:
(1) A bank’s tier 1 and tier 2 capital under the risk-based capital guidelines of the appropriate Federal banking agency, based on the bank’s most recent consolidated Report of Condition and Income filed under 12 U.S.C. 1817(a)(3); and
(2) The balance of a bank’s allowance for loan and lease losses not included in its tier 2 capital under the risk-based capital guidelines of the appropriate Federal banking agency, based on the bank’s most recent consolidated Report of Condition and Income filed under 12 U.S.C. 1817(a)(3).

(e) Company means a corporation, partnership, limited liability company, business trust, association, or similar organization and, unless specifically excluded, includes a bank and a depositary institution.

(f) Control. (1) In general. Control by a company or shareholder over another company means that:
(i) The company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company;
(ii) The company or shareholder exercises any of the powers of the directors, trustees, or partners of the other company; or
(iii) The Board determines, after notice and opportunity for hearing, that the company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company.

(2) Ownership or control of shares as fiduciary. Notwithstanding any other provision of this Regulation W, no company will be deemed to control another company by virtue of its ownership or control of shares in a fiduciary capacity, except as provided in paragraph (a)(3) of § 223.24 or if the company owning or controlling the shares is a business trust.

(3) Ownership or control of shares by subsidiary. A company will be deemed to control securities, assets, or other ownership interests owned or controlled, directly or indirectly, by any subsidiary (including a bank) of the company.

(4) Ownership or control of convertible securities. A company that owns or controls securities (including options and warrants) that are convertible, at the option of the holder or owner, into other securities, controls the other securities.

(g) Credit transaction with an affiliate means:
(1) An extension of credit to the affiliate; and
(2) An issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of the affiliate and a confirmation of a letter of credit issued by the affiliate.

(h) Depository institution means a State bank, national bank, banking association, or trust company, or an insured savings association.

(i) Equity capital means:
(1) With respect to a corporation, perpetual preferred stock, common stock, capital surplus, retained earnings, and accumulated other comprehensive income, less treasury stock, plus any other account that constitutes equity of the corporation; and
(2) With respect to a partnership, limited liability company, or other company, equity accounts similar to those described in paragraph (i)(1) of this section.

(j) Extension of credit means an extension or renewal of a loan, a grant of a line of credit, or an extension of credit in any manner whatsoever, including on an intraday basis. An extension of credit includes, without limitation:
(1) An advance by means of an overdraft, cash item, or otherwise;
(2) A lease that is the functional equivalent of an extension of credit;
(3) A purchase of a note or other obligation, including commercial paper or other debt securities (which is deemed an extension of credit to the obligor); and
(4) Any increase in the amount of, extension of the maturity of, or adjustment to the interest rate term or other material term of, an extension of credit.

(k) Financial subsidiary means:
(1) Any subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States (12 U.S.C. 24a); and
(2) Any subsidiary of a company described in paragraph (k)(1) of this section.

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

(m) GAAP means U.S. generally accepted accounting principles.

(n) General purpose credit card means a credit card issued by a bank if:
(1) The card may be used to purchase products or services from nonaffiliates of the bank;
(2) The card is widely accepted by merchants that are not affiliates of the bank for the purchase of products or services; and
(3) Less than 25 percent of the aggregate amount of products and services purchased with the card by all cardholders are purchases of products or services from an affiliate of the bank.

(o) Insured depository institution has the same meaning as in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813), but (except for purposes of § 223.16(i)) does not include any branch or agency of a foreign bank or any commercial lending company owned or controlled by a foreign bank.

(p) Insured savings association means a savings association (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)) the deposits of which are insured by the Federal Deposit Insurance Corporation.

(q) Low-quality asset means:
(1) An asset (including a security) classified as “substandard,” “doubtful,” or “loss” or treated as “other assets especially mentioned” or “other transfer risk problems” either in the most recent report of examination or inspection of an affiliate prepared by either a Federal or State supervisory agency or in any internal classification system used by the bank or the affiliate (including an asset that receives a rating that is substantially equivalent to classified in the internal system of the bank or affiliate);
(2) An asset in a nonaccrual status;
(3) An asset on which principal or interest payments are more than thirty days past due;
(4) An asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor; and
(5) A foreclosed asset designated as “other real estate owned” that has not yet been reviewed in an examination or inspection.

(r) Municipal securities has the same meaning as in section 3(a)(29) of the

(s) Nonaffiliate with respect to a bank means any person that is not an affiliate of the bank.

(t) Payment transactions is defined in § 223.16(k)(2).

(u) Principal underwriter is defined in § 223.20(c)(1).

(v) Purchase of assets means the acquisition of an asset in exchange for cash or any other consideration, including an assumption of liabilities.

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

(x) Securities affiliate means a broker or dealer that is an affiliate of the bank and is registered with the Securities and Exchange Commission.

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

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

(aa) Voting securities has the same meaning as the term “voting securities” found in 12 CFR 225.2(q).


Jennifer J. Johnson,
Secretary of the Board.

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FEDERAL RESERVE SYSTEM

12 CFR Part 250
[Miscellaneous Interpretations; Docket R–1015]

Applicability of Section 23A of the Federal Reserve Act to the Purchase of Securities From Certain Affiliates

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: Section 23A of the Federal Reserve Act restricts the ability of a member bank to fund its affiliates through asset purchases, loans, or certain other transactions (“covered transactions”). The Board is adopting an interpretation that would expand the types of asset purchases that are eligible for the exemption in section 23A(d)(6), which exempts the purchase from an affiliate of an asset that has a readily identifiable and publicly available market quotation. This interpretation would expand the ability of an insured depository institution to purchase securities from its registered broker-dealer affiliates, while ensuring that the transactions are conducted in a manner that is consistent with safe and sound banking practices.


FOR FURTHER INFORMATION CONTACT: Pamela G. Nardolilli, Senior Counsel (202/452–3289), or Mark E. Van Der Weide, Counsel (202/452–2263), Legal Division; or Molly S. Wassom, Associate Director, Division of Banking Supervision and Regulation (202/452–2305). Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Background

The Board is adopting an interpretation of section 23A(d)(6) of the Federal Reserve Act to expand the types of securities that an insured depository institution (“depository institution”) can purchase on an exempt basis from a registered broker-dealer affiliate. Section 23A of the Federal Reserve Act, originally enacted as part of the Banking Act of 1933, is designed to prevent the misuse of a member bank’s resources through “non-arm’s length” transactions with its affiliates. Section 23A limits covered transactions between a member bank and an affiliate to 10 percent of the bank’s capital stock and surplus, and limits the aggregate amount of all transactions between a member bank and all of its affiliates to 20 percent of capital stock and surplus. The purchase of assets by a bank from its affiliates is included in the definition of covered transaction and is subject to the statute’s quantitative limits.

Section 23A also contains several exemptions from the statute’s quantitative limits and collateral requirements. One exemption is contained in section 23A(d)(6), which exempts from the statute’s quantitative limits a purchase of an asset that has “a readily identifiable and publicly available market quotation” (“(d)(6) exemption”). In the past, institutions have been advised that the (d)(6) exemption was available only for the purchase of assets, the price of which was recorded in a widely disseminated publication that was readily available to the general public. Such assets included obligations of the United States, securities traded on exchanges, foreign exchange, certain mutual fund shares, and precious metals. Other marketable assets could not meet this standard.

In 1997, the Board removed certain prohibitions on transactions between a bank and its section 20 affiliates (“section 20 firewalls”). Because of the changes to the section 20 firewalls, the Board received several requests from organizations (“Petitioners”) regarding the interpretation of the (d)(6) exemption as it related to the purchase of assets from section 20 affiliates. Several Petitioners stated that, although the removal of the firewall was welcomed, section 23A continued to limit certain transactions with section 20 affiliates. Petitioners argued that certain prohibited transactions do not raise significant safety and soundness issues and that the prohibition impedes the efficient operations of the insured depository institution and the section 20 affiliate. In particular, Petitioners were concerned about the ability of an insured depository institution to purchase securities under the (d)(6) exemption because of the Board’s narrow reading of the exemption, which prevented the purchase of otherwise marketable assets.

Summary of Comments and Description of the Rule

Because of Petitioners’ requests, the Board proposed to expand the ability of a bank to purchase from a registered broker-dealer affiliate securities that, although not so widely traded as to warrant the inclusion of their prices in publications of general circulation, are actively traded and whose prices can be verified by independent reliable sources (“1998 Proposal”). Under the 1998 Proposal, a purchase of securities by an insured depository institution from its broker-dealer affiliate would meet the (d)(6) exemption if the transaction met the following criteria:

1. The broker-dealer from which the securities were purchased was registered with the Securities and Exchange Commission (“SEC”);
2. The securities had a “ready market,” as defined by the SEC in its regulation codified at 17 CFR 240.15c3–1(c)(11)(i);
3. The securities had received an investment grade rating from a nationally recognized statistical rating organization (“NRSRO”), and no NRSRO had stated that the rating was under review for a possible downgrade to below investment grade;
4. The securities were not purchased during an underwriting or within 30 days of an underwriting if an affiliate was an underwriter of the security;
5. The price paid for the securities could be verified by
   i. A widely disseminated news source;
   ii. An electronic service that provided indicative data from real-time financial networks; or
   iii. Two or more actual independent dealer quotes on the exact securities to be purchased, where the price paid was not higher than the average of the price quotes obtained from the unaffiliated broker-dealers;
6. The securities were not issued by an affiliate, unless the securities were obligations of the United States or fully guaranteed by the United States or its agencies as to principal and interest.

The Board received thirteen comments on the proposed interpretation: nine from banks and bank holding companies, three from trade associations and one from a clearing house. In addition, comments were received from eight Federal Reserve Banks. Commenters generally supported the Board’s proposed interpretation. The commenters concurred with the Board that a broader interpretation of the (d)(6) exemption, as proposed, would promote operational efficiencies in a banking organization.


2 12 U.S.C. 371c(d)(6). Although such asset purchases are exempt from the quantitative restrictions of section 23A, the (d)(6) exemption requires that the bank’s purchase be consistent with safe and sound banking practices. 12 U.S.C. 371c(a)(4).
while still ensuring that transactions are conducted in a safe and sound manner. Although the commenters uniformly supported the Board’s proposal to expand its interpretation of the (d)(6) exemption, a number of commenters expressed concerns about the specific qualifying criteria proposed by the Board. The commenters’ views regarding each of the criteria and the Board’s response are discussed below.

1. The Securities Must Be Purchased From a Broker-Dealer Registered With the SEC

In order for a purchase of securities to meet the expanded (d)(6) exemption, the Board proposed that the purchase of securities must be from a broker-dealer registered with the SEC.

One commenter specifically supported the Board’s proposed requirement that the broker-dealer affiliate be registered with the SEC. Several other commenters, however, urged the Board to loosen the requirement. One commenter argued that the Board should allow depository institutions to buy securities under the exemption from broker-dealers registered with foreign authorities. Several other commenters argued that there is no reason to limit the exemption to broker-dealers. These commenters expressed the view that non-broker-dealers may hold securities that would qualify under the terms of the 1998 Proposal, and these commenters argued that there is no policy reason for prohibiting these non-broker-dealer affiliates from using the proposed interpretation.

Broker-dealers that are registered with the SEC are subject to supervision and examination by the SEC and are required by SEC regulations to keep and maintain detailed records concerning each securities transaction conducted by the broker-dealer. In addition, SEC-registered broker-dealers have experience in determining whether a security has a “ready market” under SEC regulations, as described below. The Board believes that these factors will help ensure that banks satisfy the requirements of the expanded exemption and will assist the Federal banking agencies in monitoring such compliance.

The Board does not believe it is appropriate at this time to expand the exemption to include securities purchases from foreign broker-dealers because such entities may be subject to different levels of supervision and regulation and because of the increased difficulty associated with monitoring compliance by foreign entities. An insured depository institution can, however, request that the Board exempt securities purchases from a foreign broker-dealer, and the Board would consider these requests on a case-by-case basis in light of all the facts and circumstances.

In addition, although the proposed expanded (d)(6) exemption is limited to purchases from registered broker-dealers, the Board notes that a purchase of securities or other assets from other types of affiliates would continue to be exempt under section 23A(d)(6) if the price of the asset is routinely quoted in a widely disseminated news source and the asset was purchased at or below its current market price. The Board, in any event, expects to evaluate the continued need for the requirement as insured depository institutions and the Board gain experience with this expanded exemption.

2. The Securities Must Have a “Ready Market” as Defined by the SEC

The 1998 Proposal provided that, in order to meet the expanded (d)(6) exemption, the assets must have a “ready market,” as defined by the SEC.3 Based on public comments, the Board considered various alternative marketability definitions. Some commenters noted that the Office of the Comptroller of the Currency (“OCC”) defines “marketable” under its Investment Securities regulations to include those securities that can be sold with reasonable promptness at a price that corresponds reasonably to fair value.4 The commenters submitted that banks would be comfortable with this alternative definition of “ready market.”

One commenter argued that the SEC’s “ready market” concept was not appropriate for the (d)(6) exemption. The commenter contended that the SEC’s “ready market” concept is used in the context of determining the liquidity of a broker-dealer’s portfolio, and the commenter argued that the concept of liquidity is not analogous to the question raised in the context of the (d)(6) exemption as to whether the security was purchased at a fair market price. The commenter argued that a more appropriate standard is set forth in the “fair market price” definition in National Association of Securities Dealers (“NASD”) Rule 2730. The commenter noted that the NASD’s “fair market price” definition is one with which broker-dealers are already familiar.

In the proposed interpretation, the Board employed the “ready market” test because it believed that this definition would help ensure that a ready, competitive market exists for the securities that the bank purchases. Under the SEC’s net capital rules, a registered broker-dealer must deduct 100 percent of the carrying value of securities and certain other assets if there is not a “ready market” for the assets. The purpose of the “ready market” test is to identify securities with a liquid market to ensure that a broker-dealer promptly can sell a security and receive its value. The types of securities that meet this definition include obligations of the United States and its agencies, as well as many asset-backed, corporate debt, and sovereign debt securities. It is a standard understood by SEC-registered broker-dealers and monitored by the SEC, and if the bank is unsure of the status of a security, it can determine the status by asking how the security is treated by the broker-dealer affiliate for its own capital purposes.

The Board believes that the “ready market” test provides the best standard that is well understood by the banking and securities industries. Because a broker-dealer must adjust its capital daily—and therefore must confirm daily that its assets meet the “ready market” definition—the liquidity of purchased securities is confirmed by an independent standard on a regular basis. The Board believes that the “ready market” standard provides more specific guidance to banks than either the OCC’s “marketable” definition or NASD Rule 2730.

In addition, the Board does not believe that NASD Rule 2730 is appropriate for the exemption because the rule is concerned primarily with the price at which a security is bought. The Board disagrees with commenters who stated that only price, not liquidity, is critical under the (d)(6) exemption. The (d)(6) exemption, by its terms, applies only to assets with a “market” quotation. The Board believes that inherent in the concept of a market quotation is the idea that the asset can be bought and sold on a regular basis. Moreover, this proposal deals primarily with assets that are too thinly traded to warrant listing of their price in a widely disseminated publication, and this criterion helps support the notion that the market quote mechanism discussed below. In addition, section 23A requires

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Footnotes:
1 17 CFR 240.15c3–1(c)(11)(ii). The SEC defines a ready market as including a recognized established securities market, (i) in which there exist independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously; and (ii) where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.
2 12 CFR 1.2(f)(4).
that all covered transactions, whether or not they meet an exemption, be on terms and conditions that are consistent with safe and sound banking practices. The Board believes that it would be inconsistent with safe and sound banking practices to allow a depository institution to purchase from an affiliate unlimited amounts of a security for which no “ready market” exists.

(3) The Securities Must Be Eligible for Purchase by a State Member Bank and Must Not Be Low-Quality Assets

In the 1998 Proposal, the Board proposed that a purchase of a security would be eligible for the expanded (d)(6) exemption only if the security were rated investment grade by a nationally recognized statistical rating organization (“NRSRO”). In light of comments received on the proposal, however, the Board now proposes replacing the investment-grade requirement with requirements that the security be eligible for direct purchase by a State member bank under section 9 of the Federal Reserve Act, as determined by the Board, and that the security not be a low-quality asset (as defined in section 23A).

The Board received one comment supporting the Board’s proposed requirement that the security being purchased under the expanded (d)(6) exemption have an investment grade rating from an NRSRO. The commenter argued that this requirement would help ensure bank safety and soundness. Approximately ten commenters, however, opposed or proposed modifications to this requirement. Several commenters argued that this condition is unnecessary and overly restrictive, especially in light of the protections afforded by the Board’s other proposed criteria. One commenter noted that the focus of the (d)(6) exemption is liquidity and market information, and the commenter argued that a security can have substantial liquidity and be the subject of significant market information even if it is not investment grade. Several commenters also contended that section 23A separately addresses the question of depository institution purchases of low-quality assets from affiliates, and they contended that there is no statutory basis for importing the investment grade requirement into the (d)(6) exemption.

Other commenters proposed alternative standards. Some of them argued that non-rated securities could satisfy the Board’s concerns, provided that the purchasing depository institution conducts an independent evaluation of the security. Another commenter noted that the OCC’s regulations allow national banks to purchase securities that are rated investment grade or, if not rated, are the “credit equivalent” of a security rated investment grade. Two commenters also argued that the Board’s proposed requirement of an investment grade rating is superfluous given the OCC’s restrictions on what types of securities national banks can purchase. Several commenters also argued that, at a minimum, the investment grade rating requirement should be expanded to include high yield securities traded on the NASD’s Fixed Income Pricing System (“FIPS”), because the NASD carefully reviews a security’s volume and pricing, and the issuer’s name recognition and research following, before approving a security for FIPS quotation.

The Board originally proposed that a security must be rated by an NRSRO because it believed that such a rating ensured the marketability of a security and that the security would not be the equivalent of a “low-quality asset,” the purchase of which is prohibited by section 23A. In light of the comments, however, the Board has decided to eliminate the requirement that a security receive an investment grade rating from an NRSRO. Instead, the security will be eligible for the expanded (d)(6) exemption if it is eligible for purchase by a State member bank under section 9 of the Federal Reserve Act and is not a low-quality asset as defined by section 23A.6

Section 9 of the Federal Reserve Act permits a State member bank to purchase securities that a national bank may own pursuant to paragraph 7 of section 5136 of the Revised Statutes.7 This provision permits the purchase of a variety of securities, including obligations of State and local governments and asset-backed and corporate debt securities, that may not be rated. State member banks can purchase unrated corporate debt securities and asset-backed securities, however, only if the securities generally are the credit equivalent of a security rated investment grade.8 Moreover, a State member bank’s purchases of corporate debt securities of any one obligor are limited to 10 percent of the bank’s capital and surplus; and purchases of asset-backed securities, except certain highly rated mortgage-backed securities, are limited to 25 percent of capital and surplus.9 Institutions using this exemption would be subject to the restrictions described above and all other terms and conditions that govern the investment activities of State member banks.

The Board believes that the statutory and other restrictions placed on a State member bank’s ownership of securities also are appropriate limits on the securities eligible for this interpretation of the (d)(6) exemption. The Board further believes that the purchase must be recorded by the insured depository institution as a security purchased, and not as a loan, pursuant to the instructions of the Call Report. The Board also proposes to restrict the availability of this interpretation of the (d)(6) exemption to purchases of assets that are not low-quality assets (as defined in section 23A). Because of the inherent volatility of low-quality assets and section 23A’s special concern with respect to purchases of low-quality assets, it is inappropriate to allow banks to purchase an unlimited amount of low-quality assets from an affiliate pursuant to this interpretation. These two replacement requirements should increase the types of securities eligible for purchase under the new (d)(6) exemption, as compared with the investment grade requirement, while ensuring that purchases are consistent with section 23A’s intention that covered transactions, even exempt covered transactions, must be consistent with safe and sound banking practices.

(4) No Purchases During an Underwriting Period and for Thirty Days Thereafter

The Board’s proposed interpretation would disqualify from the expanded (d)(6) exemption an insured depository institution’s purchase of a security from an affiliate during the underwriting period for that security and for 30 days thereafter. Approximately 11 commenters expressed opposition to this criterion. The commenters believed that a 30-day underwriting exclusion is unnecessary. The commenters believed that the proposed restriction was based on misperceptions on the part of the Board about pricing volatility and conflicts of interest in the underwriting of securities.

Several commenters also argued that the Board’s concerns regarding potential conflicts of interest between

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8 See 12 CFR 1.3(i).
9 See 12 CFR 1.3.
underwriting affiliates and depository institutions were unfounded. Commenters argued that the Board had not identified any conflicts and could not demonstrate that conflicts were sufficiently serious to require the proposed 30-day underwriting exclusion.

A number of commenters argued that the Board’s proposed limitation could not be supported by the language of section 23A, which does not contain any restriction on purchases of securities during an underwriting period. Commenters also noted that section 23B does contain a provision that prohibits a depository institution from purchasing securities during the existence of any underwriting or selling syndicate if a principal underwriter of the securities is an affiliate of the depository institution. The prohibition in section 23B, however, contains an exception if the purchase or acquisition of securities has been approved by a majority of the directors of a depository institution before such securities are initially offered for sale to the public. The commenters contended that, if the Board decides to adopt the proposed restriction, the Board also should add a similar exception for purchases receiving prior director approval.

A number of commenters argued that, at a minimum, the 30-day waiting period after the underwriting should not be required. Some commenters argued that the 30-day buffer should be deleted, if in no other circumstances, in those situations in which an affiliate has been able to sell all allotted securities to third parties during the underwriting. Commenters also urged the Board to eliminate the 30-day waiting period for investment-grade securities.

Two commenters noted that, in the preamble to the proposed exemption, the Board stated that the proposed 30-day underwriting exclusion applies to bank-ineligible securities. The commenters noted, however, that the text of the proposed rule would appear to cover all securities, eligible and ineligible. The commenters urged the Board to clarify that the restriction would apply only to bank-ineligible securities.

The Board proposes to maintain the 30-Day Restriction in its final rule with one exception, because of uncertain market values of securities during and shortly after an underwriting period because of the conflicts of interest that may arise during and after an underwriting period, especially if an affiliate has difficulty selling its allotment.

The Board believes that the 30-Day Restriction should not apply to purchases of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies. The markets for these instruments generally do not require substantial market stabilization by the underwriters, and therefore it is less likely that the risks of stabilization efforts could be transferred from the securities affiliate to the depository institution.

The Board also has reviewed the restriction imposed by section 23B and its relationship to the (d)(6) exemption. As noted above, the requirements of section 23B are in addition to the requirements of section 23A. Section 23B requires the approval of a majority of the insured depository institution’s directors prior to the purchase of securities for which an affiliate is a principal underwriter. Even with the directors’ vote, however, the insured depository institution’s purchase would be subject to the quantitative limits of section 23A. If the securities are exempt under (d)(6), however, there is no quantitative limit imposed on the insured depository institution. The Board believes that given the expansion of the types of securities that insured depository institutions can purchase under this interpretation of the (d)(6) exemption, a vote of the directors is not sufficient protection to the insured depository institution if it is permitted to purchase unlimited amounts of a security before it has even been offered for sale to the public.

(5) Price Verification Methods

Several commenters concurred with the Board’s requirement for the verification of the price of each security purchased by a depository institution from an affiliated broker-dealer. At least two commenters supported the Board’s inclusion of three alternative price verification methods—(1) A widely disseminated news source; (2) an electronic service that provides indicative data from real-time financial networks; and (3) two independent dealer quotes on the exact security purchased. These commenters believed use of the two independent dealer quotes would ensure that the securities in question are readily marketable and have a price that is verifiable, which may not be the case if only one price quote were obtained.

Approximately ten commenters expressed concerns about the price verification methods proposed by the Board. One commenter suggested the Board eliminate the detailed requirement for verification. The commenter suggested that these price verification conditions are redundant in light of the “ready market” condition discussed above.

Several commenters argued that, in addition to indicative data from real-time networks, the Board should permit the use of pricing matrices proposed by the bank or its affiliate, which the commenters claimed are widely used by dealers and institutional investors and relied upon in setting prices for actual trades. The commenters noted that matrices are updated daily and are based on actual trades and dealer mark-to-market involving securities having substantially similar characteristics. The commenters stated that, so long as a security meets the credit, liquidity, and other criteria of the proposed rule, a depository institution is as assured of obtaining the security at fair market value when using a matrix as the institution is when using any of the other pricing verification methods proposed by the Board.

A number of commenters suggested that, with respect to the third proposed method of verification (verification by two independent dealer bids on the same security), the Board also should permit verification by independent bids on closely comparable securities. The commenters argued that requiring quotes on the exact security purchased was needlessly burdensome. Several commenters also contended that permitting quotes on comparable securities would recognize that, as a practical matter, it is often difficult to get quotes on the particular security being purchased.

One commenter argued that there should be a mechanism that allows Board staff to evaluate the use of comparable securities on a case-by-case basis. Such a procedure, the commenter noted, would allow depository institutions to present the comparability question in the context of a specific security. Another commenter suggested that the Board adopt a method by which Board staff may consider the permissibility of new dependable pricing mechanisms as they become available. The commenter noted that rapid developments and enhancements of information systems may produce equally dependable price verification methods in the future, which, the commenter argued, should then be included in the scope of the interpretation.

The 1998 Proposal included a price verification test because of the statutory requirement that the asset have a “readily identifiable and publicly available market quotation” and the Board’s belief that proposed criteria would meet the statutory requirement. Prior to publication of the proposal, the
Board reviewed the use of matrices and the use of comparable securities and did not believe that those price verification methods would meet the statutory standard that the quotation be "publicly available." In addition, the Board believed that the value of a security should be independently determined and not by a method that was subject to manipulation by the insured depository institution or its affiliated broker-dealer.

The Board has reviewed its position in light of the comments received on the 1998 Proposal and further analysis of the reliability of various pricing methodologies set forth in the 1998 Proposal. The Board continues to believe that the use of matrices and comparable securities to determine the price of a security may indicate a lack of liquidity in the market for that security, and the purchase of unlimited amounts of such a security from an affiliate raises safety and soundness concerns. Moreover, if a securities purchase could meet the (d)(6) exemption by the use of a matrix or comparable securities, the limitations Congress imposed in the (d)(6) exemption would be meaningless because an insured depository institution could always develop a price for a security using its own methodology. The Board believes that the use of third-party networks helps ensure that a market for the security exists and that the price the insured depository institution pays for the security is a fair market price.

Moreover, the Board has concluded that it would not be appropriate to use independent dealer quotations to establish a market price for a security under the expanded (d)(6) exemption. The Board also is concerned that a security that is not quoted routinely in a widely disseminated news source or a third-party electronic financial network may not trade in a sufficiently liquid market to justify allowing an insured depository institution to purchase unlimited amounts of such security from an affiliate. 10

The exemption also provides that a depository institution that is taking advantage of the new (d)(6) exemption must pay a price for the relevant security that is no higher than the current market quotation for the security and must ensure that the size of the transaction executed by the depository institution does not cast material doubt on the appropriateness of relying on the current market quotation for the security.

The Board agrees with commenters that there should be procedures in place for the Board to review new dependable market pricing mechanisms as they become available. The Board will continue to assess the appropriateness of new methodologies.

(6) The Securities Must Not Be Issued by an Affiliate

Finally, the proposed interpretation provided that the exemption would not apply to securities issued by an affiliate unless those securities were backed by a guarantee of the U.S. government.

Several commenters specifically supported the Board’s decision to exclude from the (d)(6) exemption those securities issued by an affiliate, including asset-backed securities issued by an affiliate and shares of a mutual fund advised by the depository institution or affiliate, unless such securities are guaranteed by the United States government. One commenter noted that inclusion of these securities within the interpretation would lead to potential self-dealing and could double capital exposure from the underwriting activity of the affiliate and the treatment of the security as an asset of the depository institution.

Two commenters argued that advised mutual funds should not be treated like other affiliates under section 23A. The commenters argued that, because a mutual fund’s profits do not accrue to its advisor but to the fund’s investors, there is little risk that a depository institution’s purchase of shares of an advised mutual fund could contribute to the unlimited funding of the affiliated fund. The commenters noted that certain mutual fund shares are permissible investments for national banks under the OCC’s regulations, mutual fund share prices are subject to comprehensive regulation under the Investment Company Act, and mutual fund share prices are published daily in The Wall Street Journal. The commenters contended that, in light of these facts, there is no justification for a blanket prohibition on depository institution purchases of affiliated mutual fund shares under the (d)(6) exemption.

Several commenters requested that the Board confirm that the sale of asset-backed securities, where the underlying assets were on the depository institution’s books immediately prior to the securities offering, would be outside the scope of section 23A. The commenters noted that the Board’s proposal should not be interpreted to extend section 23A limits to the investments of insured depository institutions in a securitization of their own loans or other assets merely because the securitization is underwritten or traded by their affiliated broker-dealer.

The proposed regulation prohibits the applicability of the (d)(6) exemption to most affiliate-issued securities because a contrary determination would permit a bank to acquire an unlimited credit exposure to an affiliate in contradiction to the purposes of section 23A. In addition, if a purchase of assets from an affiliate is also a purchase of affiliate-issued securities (if, for example, a bank purchases securities issued by one affiliate from the inventory of another affiliate), the bank has engaged in two types of covered transactions. Although the (d)(6) exemption may apply to the one-time asset purchase component of the transaction, it should not apply to exempt the ongoing investment in securities issued by an affiliate.

The Board continues to believe that safety and soundness requires restrictions on a bank’s ability to purchase securities issued by an affiliate. Such restrictions help prevent a bank from acquiring an unlimited credit exposure to its affiliates, and are consistent with other provisions of section 23A, which limit the bank’s ability to lend to an affiliate or accept the affiliate’s securities as collateral.

In light of the comments, the Board will continue to review the appropriateness of making the purchase of affiliate-issued asset-backed securities and affiliate-advised mutual funds eligible for the (d)(6) exemption.

(7) Document Retention

Five commenters expressed concerns about the Board’s proposed requirement that pricing information be retained in the insured depository institution’s files for five years. One commenter requested that the Board change the requirement to allow documents to be retained only for two years. The commenter noted that depository institutions are examined every one or two years and, accordingly, it does not make sense to require retention of documents beyond an examination cycle.

Another commenter requested that Board staff consult and work with market participants regarding what information can be made available without imposing an undue administrative burden. Other commenters requested that the Board clarify that the requirement applies to documentation concerning the actual price paid; the commenters believed that a simple notation of the price paid and source of price verification should
be sufficient. The commenters argued that otherwise this requirement would be overly burdensome for depository institutions, especially in light of the fact that historical pricing data are available from other sources.

The Board proposed a five-year standard because it believed that it would provide examiners a basis to review how the exemption was applied over time by insured depository institutions. The Board has determined to shorten the period of time necessary for the insured depository institution to retain the price verification information to two years. The Board concurs with the commenters that this period of time is consistent with the exam schedules of the institutions in question and that further information retention is not necessary in order to ensure compliance with the law. The Board does not believe that the documentation requirements are substantial, and insured depository institutions should contact their primary regulators to determine what documentation is required. At a minimum, however, the Board believes that an institution’s records should clearly show the security purchased, the seller, price and date of purchase, and evidence of the method used to determine the price.

(8) Other Issues

Failure to meet the conditions for availability of this interpretation of the (d)(6) exemption does not prevent an insured depository institution from purchasing securities or other assets. A depository institution, of course, can continue to buy securities and other assets from an affiliate subject to the quantitative limits of section 23A and can buy such securities and other assets from unaffiliated parties without any section 23A limit, so long as the purchase is otherwise authorized by law. In addition, this interpretation of the (d)(6) exemption does not interfere with the ability of a depository institution to purchase securities and other assets from affiliates pursuant to the (d)(6) exemption so long as the prices of such assets are recorded in a widely disseminated publication that is readily available to the general public.

Regulatory Flexibility Act

The Board certifies that adoption of this final rule 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.) because most small bank holding companies and insured depository institutions do not have registered broker-dealer affiliates. For this reason, most small bank holding companies would not be affected by this final rule. In addition, the rule would expand the types of transactions that an insured depository institution may engage in with its broker-dealer affiliates. Accordingly, the rule does not impose more burdensome requirements on depository institutions, their holding companies, or their affiliates than are currently applicable.

Administrative Procedure Act

Subject to certain exceptions, 12 U.S.C. 4801(b)(1) provides that new regulations and amendments to regulations prescribed by a Federal banking agency that impose additional reporting, disclosure, or other new requirements on an insured depository institution must take effect on the first day of a calendar quarter that begins on or after the date on which the regulations are published in final form. This rule is not subject to this delayed effective date requirement because the rule imposes no new requirements on existing operations of depository institutions. The rule only exempts transactions that were previously subject to the restrictions of section 23A.

Paperwork Reduction Act

The Board has determined that the final rule does not involve the collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995, 44 U.S.C. 3501 et seq.

List of Subjects in 12 CFR Part 250

Banks, banking, Federal Reserve System.

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

PART 250—MISCELLANEOUS INTERPRETATIONS

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

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

2. Section 250.246 is added to read as follows:

§ 250.246 Applicability of section 23A of the Federal Reserve Act to the purchase of a security by an insured depository institution from an affiliate.

(a) The purchase of a security by an insured depository institution from an affiliate that is a broker-dealer registered with the Securities and Exchange Commission is exempt from section 23A of the Federal Reserve Act (12 U.S.C. 371c) under paragraph (d)(6) of that statute if:

(1) The security has a “ready market,” as defined in 17 CFR 240.15c3–1(c)(11)(i);

(2) The security is eligible for a State member bank to purchase directly, subject to the same terms and conditions that govern the investment activities of a State member bank, and the institution records the transaction as a purchase of securities for purposes of the bank Call report, consistent with the requirements for a State member bank;

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

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

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

(i) The price paid by the insured depository institution is at or below the current market quotation for the security; and

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

(6) The security is not issued by an affiliate, unless the security is an obligation fully guaranteed by the United States or its agencies as to principal and interest.

(b) The purchase of the security must comply with paragraph (a)(4) of section 23A, which requires that any covered transactions between an insured depository institution and an affiliate be on terms and conditions that are consistent with safe and sound banking practices.


Jennifer J. Johnson,
Secretary of the Board.

[FR Doc. 01–11609 Filed 5–10–01; 8:45 am]

BILLING CODE 6210–01–P
FEDERAL RESERVE SYSTEM

12 CFR Part 250

[Miscellaneous Interpretations; Docket R–1016]

Applicability of Section 23A of the Federal Reserve Act to Loans and Extensions of Credit Made by a Member Bank to a Third Party

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: Section 23A of the Federal Reserve Act restricts the ability of a member bank to fund its affiliates through investments, loans, asset acquisitions, or certain other transactions ("covered transactions"). Section 23A deems transactions between a member bank and a nonaffiliated third party as covered transactions between the bank and its affiliate to the extent that proceeds of the transactions are used for the benefit of or transferred to the affiliate. The Board is adopting an interpretation and exemptions from section 23A for certain loans made by an insured depository institution ("depository institution") to customers who use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution acting exclusively as a broker or riskless principal in the transaction.

First, the Board is adopting an interpretation confirming that section 23A does not apply to extensions of credit by an insured depository institution to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as the affiliate is acting exclusively as a broker in the transaction, and the affiliate retains no portion of the loan proceeds. The Board also is exempting from section 23A that portion of a loan to a third party that an affiliate retains as a market-rate brokerage commission or agency fee.

In addition, the Board is adopting an exemption from section 23A for extensions of credit by an insured depository institution to customers that use the loan proceeds to purchase a security issued by third parties through a broker-dealer affiliate of the institution that is acting as riskless principal in the securities transaction. Finally, the Board is adopting an exemption for extensions of credit by an insured depository institution to customers that use the credit to purchase securities from a broker-dealer affiliate of the institution when that extension of credit was made pursuant to a preexisting line of credit not entered into in contemplation of the purchase of securities from an affiliate of the depository institution.


FOR FURTHER INFORMATION CONTACT: Pamela G. Nardolilli, Senior Counsel (202/452–3289), or Mark E. Van Der Weide, Counsel (202/452–2263), Legal Division; or Molly S. Wassom, Associate Director (202/452–2305), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20051.

SUPPLEMENTARY INFORMATION:

Background

Section 23A of the Federal Reserve Act, originally enacted as part of the Banking Act of 1933, is designed to prevent the misuse of a member bank’s resources through “non-arm’s length” transactions with its affiliates. To achieve this purpose, section 23A establishes both quantitative limits and qualitative restrictions on transactions by a member bank with its affiliates. The statute limits “covered transactions” between a member bank and any single affiliate to no more than 10 percent of the bank’s capital and surplus and limits aggregate covered transactions with all affiliates to no more than 20 percent of the bank’s capital and surplus. Covered transactions include extensions of credit, investments, and certain other transactions that expose the member bank to the credit risk of an affiliate. Section 23A also requires that credit exposures to an affiliate be secured by collateral, the amount of which is statutorily defined.

In addition to regulating direct transactions between a bank and its affiliates, section 23A deems any transaction by a member bank with any person to be a transaction with an affiliate to the extent that the proceeds of the transaction are “used for the benefit of, or transferred to,” that affiliate. This provision of the statute, commonly referred to as the “attribution rule,” is designed to prevent an evasion of the quantitative limits and collateral requirements of section 23A through the use of a third party that serves as a conduit for the flow of funds from the bank to its affiliates.

The Board and its staff have taken the position that section 23A applies to loans made by a bank to a third party, where the proceeds of the loans are used to purchase various types of assets from the bank’s affiliate. Section 23A also gives the Board authority to grant exemptions from the statute’s restrictions. Specifically, the statute permits the Board to exempt transactions or relationships, by regulation or by order, if such exemptions are “in the public interest and consistent with the purposes of this section.”

In August 1997, the Board adopted Operating Standards governing the activities of section 20 subsidiaries. Operating Standard #6 allows a bank to extend credit to a customer to purchase securities from a section 20 affiliate during the underwriting period for the securities, pursuant to a preexisting line of credit not entered into in contemplation of the purchase of affiliate-underwritten securities. In adopting Operating Standard #6, the Board stated that it would consider whether an exemption from section 23A for transactions permitted under the Operating Standard would be appropriate.

Proposal

On June 10, 1998, the Board proposed two exemptions from the quantitative limitations and collateral restrictions of section 23A for loans made by an insured depository institution, the proceeds of which are used to buy securities from a registered broker-dealer affiliate of the depository institution. The first exemption proposed by the Board applied to loans made by a depository institution to its customers for the purpose of purchasing third-party securities through a registered broker-dealer affiliate of the institution that is acting as broker or riskless principal in the securities business to refer to a transaction in which

Footnotes:
1. 12 U.S.C. 371c. Although section 23A originally applied only to member banks, Congress has since applied the section to insured nonmember banks and insured savings associations in the same manner as it applies to member banks. See 12 U.S.C. 1828(i); 12 U.S.C. 1468.
2. “Capital and surplus” has been defined by the Board as tier 1 and tier 2 capital plus the balance of an institution’s allowance for loan and lease losses not included in tier 2 capital. 12 CFR 250.242.
4. 12 U.S.C. 371c(a)(2). Section 23A defines an affiliate to include, among other things, “any company that controls the member bank and any other company that is controlled by the company that controls the member bank.” 12 U.S.C. 371c(b)(1).
6. See, e.g., Letter from General Counsel of the Board to Ms. Charla Jackson (August 26, 1996) (crop-production loan to farmer who leases farm land from a bank’s affiliate is covered by section 23A).
10. “Riskless principal” is the term used in the securities business to refer to a transaction in which...
transaction ("Broker/Riskless Principal Exemption"). As proposed, the exemption was applicable even if the broker-dealer affiliate of the depository institution retained part of the loan proceeds as a brokerage commission or, in the case of a riskless principal transaction, a mark-up for effecting the securities transaction.

The second proposed exemption applied to extensions of credit by a depository institution to a customer made pursuant to a preexisting line of credit, the proceeds of which were used to purchase securities underwritten or sold as principal by a registered broker-dealer affiliate of the institution ("Preexisting Line of Credit Exemption"). The proposal also required that the line of credit not have been entered into in contemplation of the purchase of securities from an affiliate and that either the line of credit be unrestricted or the extension of credit be clearly consistent with any restrictions imposed under the line.

Summary of Comments and Final Rule

The Board received approximately 14 comments on the proposed exemptions. The commenters included ten banks or bank holding companies, and four trade associations that represent the banking industry. The Board also received seven comments from the Federal Reserve Banks. The commenters overwhelmingly supported the goals of the Board’s proposals, which they believed would provide benefits to both consumers and depository institutions without raising the types of concerns that section 23A was intended to address, but many commenters argued that the Board should achieve its goals through alternative means.

Broker/Riskless Principal Exemption

Commenters generally agreed with the position taken in the Board’s proposal that loans by an insured depository institution to a third party to purchase securities through a broker-dealer affiliate of the depository institution that is acting exclusively in a brokerage or riskless principal capacity should not be within the ambit of section 23A. Many commenters, however, argued that the Board should not adopt an exemption to section 23A that applies only to broker-dealers and securities. These commenters contended that a better course of action would be for the Board to issue an interpretation broader in scope than the proposed exemption. The interpretation suggested by the commenters would confirm that in no case is a loan from a depository institution to a third party subject to section 23A when the third party purchases assets through a bank affiliate acting exclusively as broker or agent for the third party (regardless of the affiliate’s retention of brokerage or agency fees).

The commenters argued that adoption of a specific exemption for securities brokerage transactions involving broker-dealer affiliates implies that, absent a grant of exemption, the Board considers brokerage or agency transactions involving other types of affiliates and assets to be covered by section 23A. The commenters contended that, if an affiliate is acting only as broker or agent in a transaction, the affiliate does not receive a “benefit” from the transaction, and the transaction cannot be viewed as fitting within section 23A. One commenter, however, found support for the Board’s decision to issue an exemption for riskless principal transactions, noting that there could be disagreement as to whether riskless principal transactions should be viewed as within the scope of section 23A.

The exemption from section 23A proposed by the Board would have applied when an insured depository institution lends to its customers for the purpose of purchasing third-party securities through a registered broker-dealer affiliate acting solely as broker or riskless principal in a securities transaction with the customer. The Board believed that the exemption would be consistent with the purposes of section 23A because of the negligible risk that loans made pursuant to the exemption would be used as a source of funding from an insured depository institution to its broker-dealer affiliate. As proposed, the exemption only would have been available when the securities being sold were not in the inventory of the broker-dealer. Accordingly, the loan proceeds, although initially transferred to the affiliate to purchase the securities, would be transferred in turn (minus a brokerage fee or riskless principal mark-up) to the seller of the securities, which would not be an affiliate of the depository institution.

The Board concurs with the commenters that extensions of credit by a depository institution to customers to purchase third-party securities and assets through an affiliate of the depository institution that is acting exclusively in a brokerage or agency capacity fall outside of the reach of section 23A to the extent that the affiliate retains no part of the loan proceeds. Accordingly, rather than issuing the proposed exemption from section 23A to cover certain types of brokerage transactions, the Board is issuing a broader interpretation, as requested by the commenters. The interpretation confirms that section 23A does not apply when a depository institution’s borrower uses loan proceeds to enter into agency transactions with an affiliate of the depository institution so long as the securities or other assets being purchased by the borrower are not issued by, or sold from the inventory of, any affiliate of the depository institution and to the extent that no affiliate retains any portion of the loan proceeds.

A somewhat different analysis under section 23A is required, however, when an affiliate retains a portion of a depository institution’s loan to a third party as a brokerage commission or agency fee. The portion of the loan used by the borrower to pay the affiliate’s commission or fee would be subject to section 23A because that transaction fee represents the proceeds of a loan retained and used for the benefit of an affiliate under the attribution rule.

In accordance with its original proposal, the Board has determined to exempt from section 23A that portion of a loan from a depository institution to an unaffiliated customer that is retained by an affiliate of the institution as a market-rate brokerage fee or agency commission; that is, a fee or commission no greater than that prevailing at the same time for comparable agency transactions entered into by the affiliate with persons who are neither affiliates nor borrowers from an affiliated depository institution, as required by section 23B of the Federal Reserve Act (12 U.S.C. 371c–1). The Board expects that such transaction fees will be nominal amounts and will represent a small percentage of the overall agency transaction and, accordingly, believes that these fees present little opportunity for a depository institution to benefit its broker-dealer affiliate.

Finally, a loan from a depository institution to a customer who engages in a riskless principal trade through a broker-dealer affiliate of the depository institution would be covered transactions under section 23A. Riskless principal trades—although the functional equivalent of securities brokerage transactions—involves the purchase of a security by the depository institution’s broker-dealer affiliate.
Accordingly, the broker-dealer retains the loan proceeds at least for some moment in time.\footnote{For this reason, riskless principal trades involve risks that are different from securities brokerage transactions. See, e.g., Exchange Act Rel. No. 33,743, reprinted in [1993–1994] Fed. Sec. L. Rep. (CCH) 85,526 (March 9, 1984).} As noted in the proposing release, there is negligible risk that loans made by a depository institution to borrowers to engage in riskless principal trades through a broker-dealer affiliate of the depository institution would be used to fund the broker-dealer. For this reason, the Board believes that it is appropriate to adopt the proposed exemption from section 23A to cover riskless principal securities transactions engaged in by depository institution borrowers through broker-dealer affiliates of the depository institution.\footnote{As in the proposed rule, the final rule would make the exemption for riskless principal transactions would not apply if the broker-dealer affiliate sold securities to the third-party borrower out of its own inventory or out of the inventory of another affiliate of the depository institution. This condition is not intended to make the exemption unavailable when the broker-dealer affiliate sells as principal to the third-party borrower a security that it purchased immediately prior to the sale in order to effect the riskless principal transaction requested by the borrower, so long as the broker-dealer affiliate did not purchase the security from another affiliate of the depository institution.} This grant of exemption is applicable even if the broker-dealer retains a portion of the loan proceeds as a market-rate mark-up for executing the riskless principal securities trade.

**Preexisting Line of Credit Exemption**

Approximately a dozen commenters offered specific comments on the proposed preexisting line of credit exemption. A majority of these commenters supported the Board’s proposed exemption and concurred with the Board’s view that exempting an extension of credit pursuant to a preexisting credit line from section 23A would not raise safety and soundness concerns.

Several commenters expressed concern about the requirement that the credit line be “preexisting.” The commenters urged the Board to adopt other safeguards in lieu of the “preexisting” requirement. For example, one commenter argued that the Board should only require that banks conduct independent credit analyses before granting credit. Other commenters offered alternative standards.

The Board is adopting the exemption for preexisting lines of credit substantially as proposed. As noted above, the exemption applies to extensions of credit by a depository institution made pursuant to a preexisting line of credit, the proceeds of which are used to buy securities underwritten or held as principal by a registered broker-dealer affiliate of the depository institution. Under the exemption, extensions of credit must be made by a depository institution pursuant to a preexisting line of credit that was not entered into in contemplation of the purchase of securities by the borrower from an affiliate of the institution, and the extension of credit must be consistent with any restrictions imposed by the line. The Board believes that the “preexisting” and other requirements for such lines of credit are important safeguards to ensure that the credit was not extended by the depository institution for the purpose of inducing a borrower to purchase securities from or issued by an affiliate.

Several of the commenters that opposed the requirement that the line of credit be “preexisting” argued that, if, despite their objections, the Board decided to use a “preexisting” requirement as part of this exemption, the Board should adopt a safe harbor. These commenters urged the adoption of a five-day safe harbor, in which the credit line would meet the “preexisting” requirement if the line were established at least five days prior to the customer’s securities transaction with the bank’s broker-dealer affiliate. The Board does not regard as necessary or appropriate a five-day safe harbor for determining whether a line of credit is truly “preexisting.” The Board intends that this exemption be used in good faith by depository institutions. As noted in the proposing release, in determining whether the exemption is being used in good faith, examiners will consider the timing of the line of credit. In addition, examiners will consider the conditions imposed on the credit line and whether the line of credit has been used for purposes other than the purchase of securities from an affiliate. The Board will issue additional examiner guidance regarding the “preexisting” requirement should such guidance prove necessary.

Some commenters objected that the proposed Preexisting Line of Credit Exemption was not necessary to cover a borrower’s purchases of bank-eligible securities from an affiliate, which the commenters apparently believed fell outside the purview of section 23A. The attribution rule of section 23A does not, however, distinguish between bank-eligible and bank-ineligible securities: A loan from a depository institution, the proceeds of which are used by the borrower to buy securities underwritten or held as principal by an affiliate of the depository institution, would be covered by section 23A regardless of whether the securities purchased are bank-eligible or bank-ineligible. To avoid having the loan covered by the quantitative limits of section 23A, the loan would need to qualify for an exemption under the statute—either the Preexisting Line of Credit Exemption being adopted by the Board today or some other exemption (e.g., the exemption in section 23A(d)(4) for obligations fully secured by deposit accounts or U.S. government obligations).

At the request of one commenter, the Board also is clarifying that the Preexisting Line of Credit Exemption may not be used in circumstances in which the line has been merely pre-approved. Accordingly, for an extension of credit to qualify for this exemption, the credit line must be, in fact, “preexisting” and not merely “preapproved.”

**Regulatory Flexibility Act**

The Board certifies that adoption of these rules 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.) because the Board’s action creates exemptions and clarifies certain interpretations under section 23A of the Federal Reserve Act. Accordingly, the Board’s action does not impose more burdensome requirements on depository institutions, their holding companies, or their affiliates than are currently applicable.

**Administrative Procedure Act**

Subject to certain exceptions, 12 U.S.C. 4801(b)(1) provides that new regulations and amendments to regulations prescribed by a Federal banking agency that impose additional reporting, disclosure, or other new requirements on an insured depository institution must take effect on the first day of a calendar quarter that begins on or after the date on which the regulations are published in final form. These rules are not subject to this delayed effective date requirement because the rules impose no new requirements on existing operations of depository institutions. The rules only exempt transactions that were previously subject to the restrictions of section 23A.

**Paperwork Reduction Act**

The Board has determined that the rules do not involve the collection of information pursuant to the provisions

List of Subjects in 12 CFR Part 250

Banks, banking, Federal Reserve System.

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

PART 50—MISCELLANEOUS INTERPRETATIONS

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

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

2. Section 250.243 is added to read as follows:

§ 250.243 Applicability of section 23A of the Federal Reserve Act to loans and extensions of credit by an insured depository institution to a nonaffiliate to enable the nonaffiliate to purchase an asset through an affiliate of the institution that is acting exclusively in an agency or brokerage capacity in the transaction.

(a) The attribution rule of section 23A of the Federal Reserve Act (12 U.S.C. 371c) provides that “a transaction by a member bank with any person shall be deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate.” 1 The Board has considered the question of whether a loan or extension of credit by an insured depository institution (“depository institution”) to an unaffiliated borrower who uses the proceeds of the transaction to purchase an asset through an affiliate of the institution that is acting exclusively as an agent or broker in the transaction should be subject to the attribution rule because of the limited benefit that the affiliate receives when it acts only as an agent or broker in the transaction. The Board believes that a loan by a depository institution to an unaffiliated borrower who uses the proceeds of the loan to purchase an asset through an affiliate of the institution that is acting exclusively in an agency or brokerage capacity is not covered by section 23A if the affiliate retains no portion of the loan proceeds as a fee or commission for its services.

(b) A somewhat different analysis is required when the affiliate acting as agent or broker in the transaction retains a portion of the loan proceeds as a fee or commission. In such a case, the portion of the loan not retained by the affiliate as a fee or commission still would be outside the coverage of section 23A. On the other hand, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board hereby grants an exemption from section 23A for such fees and commissions.

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

(d) The Board also notes that the transactions described above (including the loan to the third-party borrower and any fee or commission paid to the affiliate of the depository institution out of the loan proceeds) would be subject to the market terms requirement of section 23B, which applies to “any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person.” 2

3. Section 250.244 is added to read as follows:

§ 250.244 Exemption from section 23A of the Federal Reserve Act for certain loans and extensions of credit by an insured depository institution to a nonaffiliate to enable the nonaffiliate to purchase securities through a registered broker-dealer affiliate of the institution that is acting exclusively as riskless principal in the securities transaction.

(a) A loan or extension of credit by an insured depository institution (“depository institution”) to any person other than an affiliate of such depository institution is exempted from section 23A of the Federal Reserve Act (12 U.S.C. 371c) if—

(1) The loan or extension of credit is on terms that are consistent with safe and sound banking practices; and

(2) The proceeds of the loan or extension of credit are used to purchase a security through an affiliate of the depository institution that is a broker-dealer registered with the Securities and Exchange Commission, where

(i) The affiliate is acting exclusively as a riskless principal in the securities transaction; and

(ii) The security is not issued or underwritten by, or sold out of the inventory of, any affiliate of the depository institution.

(b) This grant of exemption is applicable to a loan or extension of credit covered by paragraph (a) of this section even if a portion of the proceeds of the loan or extension of credit is used by the borrower to pay a riskless principal mark-up to the affiliate, provided that the mark-up is substantially the same as, or lower than, those prevailing at the same time for comparable transactions with or involving other nonaffiliated companies, in accordance with section 23B of the Federal Reserve Act (12 U.S.C. 371c–1).

4. Section 250.245 is added to read as follows:

§ 250.245 Exemption from section 23A of the Federal Reserve Act for certain loans and extensions of credit by an insured depository institution to a nonaffiliate made pursuant to a preexisting line of credit.

Section 23A of the Federal Reserve Act (12 U.S.C. 371c) shall not apply to an extension of credit by an insured depository institution (“depository institution”) to any person other than an affiliate of such depository institution if—

(a) The proceeds of the loan or extension of credit are used to purchase a security from or through an affiliate of the depository institution that is a broker-dealer registered with the Securities and Exchange Commission; and

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


Jennifer J. Johnson,
Secretary of the Board.

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FEDERAL RESERVE SYSTEM

12 CFR Part 250

[Miscellaneous Interpretations; Docket No. R–1104]

Application of Sections 23A and 23B of the Federal Reserve Act to Derivative Transactions With Affiliates and Intraday Extensions of Credit to Affiliates

AGENCY: Board of Governors of the Federal Reserve System.


ACTION: Interim rules with request for public comments.

SUMMARY: The Board of Governors of the Federal Reserve System is adopting on an interim basis rules to address the application of sections 23A and 23B of the Federal Reserve Act to credit exposure arising out of derivative transactions between an insured depository institution and its affiliates and intraday extensions of credit by an insured depository institution to its affiliates. The rules require institutions to adopt policies and procedures reasonably designed to monitor, manage, and control credit exposures arising out of the transactions and clarify that the transactions are subject to section 23B.

DATES: The interim rules are effective January 1, 2002. Comments must be submitted on or before August 15, 2001.

ADDRESSES: Comments should refer to Docket No. R–1104 and should be sent to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551 (or mailed electronically to regs.comments@federalreserve.gov). Comments addressed to Ms. Johnson also may be delivered to the Board’s mail room between the hours of 8:45 a.m. and 5:15 p.m. weekdays and, outside of those hours, to the Board’s security control room. Both the mail room and the security control room are accessible from the Eccles Building courtyard entrance, located on 20th Street, NW., between Constitution Avenue and C Street, NW. Members of the public may inspect comments in Room MP–500 of the Martin Building between 9 a.m. and 5 p.m. weekdays.

FOR FURTHER INFORMATION CONTACT: Pamela G. Nardolilli, Senior Counsel (202/452–3289), or Mark E. Van Der Weide, Counsel (202/452–2263), Legal Division; Michael G. Martinson, Associate Director (202/452–3640), or Heidi W. Richards, Assistant Director (202/452–2598), Division of Banking Supervision and Regulation; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Background

Sections 23A and 23B of the Federal Reserve Act are intended to limit the risks to an insured depository institution ("institution") from transactions with its affiliates.

23A and 23B also limit the ability of an institution to transfer to its affiliates the subsidy arising from the institution's access to the Federal safety net.

Section 23A achieves these goals in three major ways. First, it limits the aggregate amount of an insured depository institution’s “covered transactions” with any single affiliate (other than a financial subsidiary of the institution) to no more than 10 percent of the institution’s capital and surplus, and the aggregate amount of covered transactions with all affiliates combined (including financial subsidiaries of the institution) to no more than 20 percent of the institution’s capital and surplus. Covered transactions include purchases of assets from an affiliate, extensions of credit to an affiliate, guarantees issued on behalf of an affiliate, and certain other transactions that expose an institution to an affiliate’s credit or investment risk.

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

Section 23B protects an insured depository institution by requiring that transactions between the institution and its affiliates be on market terms; that is, on terms and under circumstances that are substantially the same, or at least as favorable to the institution, as those prevailing at the time for comparable transactions with unaffiliated companies. The market terms requirement of section 23B applies to any covered transaction (as defined in section 23A) with an affiliate as well as a broad range of other transactions, such as a sale of securities or other assets to an affiliate and a contract for the payment of money or furnishing of services to an affiliate.

The Gramm-Leach-Bliley Act ("GLB Act") requires the Board to adopt, by May 12, 2001, final rules under section 23A to "address as covered transactions credit exposure arising out of derivative transactions between [insured depository institutions] and their affiliates and intraday extensions of credit by [insured depository institutions] to their affiliates." The Board is adopting the interim final rules explained below pursuant to the amendments to section 23A contained in the GLB Act.

Explanation of Interim Rules

A. Derivative Transactions

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

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

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

The Board believes that derivative transactions between an insured depository institution and an affiliate are subject to section 23B under the

1 Section 23A originally was enacted as part of the Banking Act of 1933 and applied only to banks that were members of the Federal Reserve System.

2 GLB Act section 121(b)(3) (codified at 12 U.S.C. 371c(f)(3)).
express terms of the statute. The Board has not ruled on the question of whether
derivative transactions between an
insured depository institution and its
affiliates are covered transactions under
section 23A.

Derivative transactions between an
insured depository institution and an
affiliate resemble section 23A covered
transactions in many respects. Such
transactions may expose institutions to
the credit risk of their affiliates.

Although the typical institution-affiliate
derivative transaction does not create
current credit exposure for the
institution at the inception of the
transaction, an institution may incur
current credit exposure to an affiliate
during the term of a derivative
transaction and nearly always faces
some amount of potential future
exposure on such a transaction. The
credit exposure on a derivative
transaction with an affiliate poses a risk
to the safety and soundness of the bank
that is similar in many respects to the
risk posed by a loan to an affiliate, and
may be more volatile and indeterminate
than the credit exposure created by a
loan.

Determining the appropriate
treatment for derivative transactions
under section 23A is a complex and
important endeavor. In light of the
complexities of the subject matter and
in light of the May 12, 2001, statutory
schedule in the GLB Act, the Board is
taking the following two steps to
address institution-affiliate derivative
transactions under sections 23A and
23B. First, the Board is publishing this
interim rule, which (i) requires, under
section 23A as amended by the GLB
Act, that an institution establish and
maintain policies and procedures
reasonably designed to manage the
credit exposure arising from the
institution’s derivative transactions with
affiliates and (ii) clarifies that
institution-affiliate derivative
transactions are subject to the market
terms requirement of section 23B. The
policies and procedures must at a
minimum provide for monitoring and
controlling the credit exposure arising
from the institution’s derivative
transactions with each affiliate, and all
affiliates in the aggregate, and ensuring
that the institution’s derivative
transactions with affiliates comply with
section 23B. In addition, the interim
rule defines the term “derivative
transaction” to mean any derivative
contract covered by the Board’s capital
adequacy guidelines (which includes
most interest-rate, currency, equity, and
commodity derivative contracts) and
any similar derivative contract,
including credit derivative contracts.

Second, the Board has included
provisions in the proposed Regulation
W issued concurrently with this interim
rule to address further the credit
exposure associated with derivative
transactions. Regulation W proposes a
set of questions on measures in addition
to those contained in this interim rule
that could be applied to institution-
affiliate derivative transactions under
section 23A. In connection with this
interim rule and proposed Regulation
W, the Board solicits public comment
on the most appropriate treatment under
section 23A of the credit exposure
arising from derivative transactions.

As noted above, regardless of how the
Board ultimately addresses credit
exposure on derivative transactions
between an institution and an
affiliate under section 23A, these
transactions are subject to the market
terms requirement of section 23B.
Accordingly, each institution should
have in place credit limits on its
derivatives exposure to affiliates that are
at least as strict as the credit limits the
institution imposes on unaffiliated
companies that are engaged in similar
businesses and are substantially
equivalent in size and credit quality.
Similarly, each institution should
monitor derivatives exposure to
affiliates in a manner that is at least as
tough as it uses to monitor derivatives
exposure to comparable unaffiliated
companies. In addition, each institution
should price, and require collateral in,
derivative transactions with affiliates in
a way that is at least as favorable to the
institution as the way the institution
would price, or require collateral in, a
derivative transaction with comparable
unaffiliated counterparties.

Although the Board continues to
explore and analyze the complex issue
of how best to address institution-
affiliate derivative transactions under
section 23A, the Board has not made a
determination at this time that the credit
exposure arising from such derivatives
ought to be made subject to all the
requirements of section 23A. The Board
continues to collect information
regarding the derivatives practices of
insured depository institutions and asks
for additional data on such practices in
order to assist the Board in determining
whether the approach set forth in the
interim rule would suffice to prevent
institutions from incurring material
credit exposure to affiliates on
derivative transactions. It appears that
several of the larger insured depository
institutions that participate in the
derivatives markets increasingly manage
credit risk arising from derivatives
exposure to financial institutions by
requiring such counterparties to post
collateral. The Board understands that
these institutions generally require full
collateralization of their current credit
exposure (i.e., positive net mark-to-
market values recalculated daily based
on the previous day’s exposures) on
derivative transactions with financial
institutions above a relatively small
threshold amount.

The Board requests information
regarding (i) how institutions currently
measure, monitor, and limit derivatives
credit exposure to unaffiliated
companies; (ii) whether institutions
include an estimate of potential future
exposure in their measurement of credit
exposure to unaffiliated derivatives
counterparties and, if so, how
institutions estimate potential future
exposure on a derivative transaction;
(iii) in what circumstances and to what
extent institutions require unaffiliated
counterparties to post collateral to
secure derivatives credit exposure; (iv)
what types of collateral institutions
accept to secure derivatives credit
exposure (and what haircuts are used
for the various collateral types); (v) how
often institutions mark to market (and
require additional collateral with
respect to) their derivative transactions
with unaffiliated counterparties; (vi)
how institutions price derivative
transactions with unaffiliated
counterparties; and (vii) how large the
uncollateralized derivatives credit
exposures are that institutions have to
unaffiliated companies.

After a more complete review and
analysis of the credit risk mitigation
practices of insured depository
institutions participating in the
derivatives markets and of the public
comments received on this interim rule
and Regulation W, the Board may
decline to subject credit exposure on
institution-affiliate derivatives to some
or all of the requirements of section
23A.

B. Intraday Extensions of Credit

As noted above, the GLB Act requires
the Board to address as covered
transactions under section 23A the
credit exposure arising from intraday
extensions of credit by insured
depository institutions to their affiliates.
Insured depository institutions regularly
provide transaction accounts to their
affiliates in conjunction with providing

3 In addition to applying to covered transactions as defined in section 28A, the market terms requirement of section 23B applies broadly to, among other things, “[t]he payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise.” 12 U.S.C. 371c–1(a)(2)(C).

Institution-affiliate derivatives generally involve a contract or agreement to pay money to the affiliate or furnish risk management services to the affiliate.
payment and securities clearing services. As in the case of unaffiliated commercial customers, these accounts are occasionally subject to overdrafts during the day that are repaid in the ordinary course of business. The Board has not to date ruled on whether these or other types of intraday credit extensions are covered transactions under section 23A or are subject to the market terms requirement of section 23B.

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

As with institution-affiliate derivative transactions, the Board is taking a two-step approach to addressing intraday credit extensions by an institution to an affiliate under sections 23A and 23B. First, the Board is publishing this interim final rule. The interim rule (i) requires, under section 23A, that institutions establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from the institution’s intraday extensions of credit to affiliates and (ii) clarifies that intraday extensions of credit by an insured depository institution to an affiliate are subject to the market terms requirement of section 23B. The policies and procedures must at a minimum provide for monitoring and controlling the institution’s intraday credit exposure to each affiliate, and all affiliates in the aggregate, and ensuring that the institution’s intraday credit extensions to affiliates comply with section 23B.

Second, the Board has proposed in Regulation W an alternative approach that would subject certain intraday credit extensions to section 23A. The Board specifically invites public comment on whether the Board’s final rule on intraday credit extensions under section 23A should reflect the approach taken in this interim rule, the approach set forth in proposed Regulation W, an approach that more fully subjects intraday credits to section 23A, or another approach.

C. Delayed Effective Date

The GLB Act authorizes the Board to delay the effective date of its final rule under section 23A on derivative transactions and intraday credit extensions “for such period as the Board deems necessary or appropriate to permit banks to conform their activities to the requirements of the final rule without undue hardship.” 12 U.S.C. 24232 Federal Register

Pursuant to this authority, the Board has determined to delay the effective date of these interim final rules until January 1, 2002, to allow institutions an appropriate amount of time to put in place the policies and procedures required by the rules. The delayed effective date also will provide the Board with an opportunity to revise the interim rules to reflect public comments as necessary.

Regulatory Flexibility Act

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603(a)), the Board must publish an initial regulatory flexibility analysis with this rulemaking. The rules implement provisions of section 121 of the GLB Act that require the Board to adopt final rules under section 23A of the Federal Reserve Act to address as a covered transaction the credit exposure arising out of derivative transactions between insured depository institutions and their affiliates and intraday extensions of credit by institutions to their affiliates.

The interim rules require insured depository institutions to establish and maintain policies and procedures regarding their derivative transactions with affiliates and intraday credit extensions to affiliates. The policies and procedures required by the rules are necessary to ensure that institutions conduct these activities in a safe and sound manner and to enable the Board to execute properly its supervisory function. These requirements apply to all insured depository institutions, regardless of size, engaged in these activities. The Board believes that institutions that engage in these activities, in most cases, already have policies and procedures in place to manage the risks of these activities.

The Board specifically seeks comment on the likely burden that the interim rules will impose on insured depository institutions that engage in derivative transactions with affiliates or extend credit on an intraday basis to affiliates.

Administrative Procedure Act

The provisions of these rules are effective on January 1, 2002, on an interim basis. Pursuant to 5 U.S.C. 553, the Board finds that it is impracticable to issue these rules in proposed form and that there is good cause to issue these rules as interim final rules due to the fact that the GLB Act requires the Board to adopt final rules addressing the credit exposure arising from derivative transactions between institutions and affiliates and intraday extensions of credit from institutions to affiliates by May 12, 2001. The Board is seeking public comment on all aspects of the interim rules and will amend the rules as appropriate after reviewing the comments.

Subject to certain exceptions, 12 U.S.C. 4802(b)(1) provides that new regulations and amendments to regulations prescribed by a Federal banking agency that impose additional reporting, disclosure, or other new requirements on an insured depository institution must take effect on the first day of a calendar quarter that begins on or after the date on which the regulations are published in final form. In accordance with this provision of the Administrative Procedure Act, these interim rules do not become effective until January 1, 2002.

Paperwork Reduction Act

The Board has determined that the interim rules do not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 et seq.).

Plain Language

Section 722 of the GLB Act requires the Board to use “plain language” in all proposed and final rules published after January 1, 2000. In light of this requirement, the Board has sought to present its interim rules in a simple and straightforward manner. The Board invites comments on whether there are additional steps the Board could take to make the rules easier to understand.

List of Subjects in 12 CFR Part 250

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

PART 250—MISCELLANEOUS INTERPRETATIONS

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

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

2. Section 250.247 is added to read as follows:

§ 250.247 Application of sections 23A and 23B of the Federal Reserve Act to derivative transactions between insured depository institutions and their affiliates.

(a) Derivative transactions between an insured depository institution and its affiliates are subject to the market terms requirement of section 23B(a)(1) of the Federal Reserve Act (12 U.S.C. 371c–1(a)(1)).

(b) An insured depository institution must establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from its intraday extensions of credit to affiliates in a safe and sound manner. The policies and procedures must at a minimum provide for:

(1) Monitoring and controlling the credit exposure arising from the institution’s derivative transactions with each affiliate and all affiliates in the aggregate; and

(2) Ensuring that the institution’s derivative transactions with affiliates comply with section 23B.

(c) For purposes of this regulation, derivative transactions include any derivative contract listed in paragraphs A. III. E. 1. a. through d. of appendix A to 12 CFR part 225 and any similar derivative contract, including credit derivative contracts.

3. Section 250.248 is added to read as follows:

§ 250.248 Application of sections 23A and 23B of the Federal Reserve Act to intraday extensions of credit by insured depository institutions to their affiliates.

(a) Intraday extensions of credit by an insured depository institution to its affiliates are subject to the market terms requirement of section 23B(a)(1) of the Federal Reserve Act (12 U.S.C. 371c–1(a)(1)).

(b) An insured depository institution must establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from its intraday extensions of credit to affiliates in a safe and sound manner. The policies and procedures must at a minimum provide for:

(1) Monitoring and controlling the credit exposure arising from the institution’s intraday extensions of credit to each affiliate and all affiliates in the aggregate; and

(2) Ensuring that the institution’s intraday extensions of credit to affiliates comply with section 23B.


Jennifer J. Johnson,
Secretary of the Board.

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