FEDERAL RESERVE BANK
OF DALLAS

DALLAS, TEXAS
75265-5906

February 10, 2003

Notice 03-09

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

SUBJECT

**Adoption of Regulation W Implementing Sections 23A and 23B
of the Federal Reserve Act**

DETAILS

On December 12, 2002, Regulation W, the rule that comprehensively implements Sections 23A and 23B of the Federal Reserve Act, was published in the *Federal Register* (this Bank's **Notice 02-67** dated December 13, 2002).

Sections 23A and 23B and Regulation W limit the risks to a bank from transactions between the bank and its affiliates and limit the ability of a bank to transfer to its affiliates the subsidy arising from the bank's access to the Federal safety net (i.e., lower cost insured deposits, the payment system, and the discount window). The statute and rule accomplish these purposes by imposing quantitative and qualitative limits on the ability of a bank to extend credit to, or engage in certain other transactions with, an affiliate. Transactions between a bank and a nonaffiliate that benefit an affiliate of the bank are covered by the statute and regulation as well, through the well-established "attribution" principle. However, certain transactions that generally do not expose a bank to undue risk or abuse the safety net are exempted from coverage under Regulation W.

The Gramm-Leach-Bliley Act (GLBA) increased the range of affiliations permitted to banking organizations. A key premise of GLBA was that sections 23A and 23B would limit the risk to depository institutions from these broader affiliations and eliminate the need for extensive prior review by the bank regulatory agencies. Given the enhanced role of sections 23A and 23B in risk management after GLBA, it is essential that examiners and other supervisory

staff review intercompany transactions for compliance with the statutes and Regulation W. Reviews for compliance with the affiliate transaction rules should be frequent and rigorous, and any violations or potential violations should be resolved quickly.

The rule becomes effective April 1, 2003.

ATTACHMENTS

A copy of the Board's **SR Letter 03-2** dated January 9, 2003, which includes a summary of significant issues, and a copy of the Board's guidance , which provides a comprehensive review of the rule, are attached.

MORE INFORMATION

For more information, please contact Jane Anne Schmoker, Legal Department, (214) 922-5101. Paper copies of this notice or previous Federal Reserve Bank notices can be printed from our web site at **http://www.dallasfed.org/banking/notices/index.html**.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 03-2
January 9, 2003

TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE SUPERVISORY AND EXAMINATION STAFF AT EACH FEDERAL RESERVE BANK AND TO DOMESTIC AND FOREIGN BANKING ORGANIZATIONS SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: Adoption of Regulation W Implementing Sections 23A and 23B of the Federal Reserve Act

On December 12, 2002, Regulation W, the rule that comprehensively implements sections 23A and 23B of the Federal Reserve Act, was published in the *Federal Register* .[1] The rule is effective April 1, 2003.

Sections 23A and 23B and Regulation W limit the risks to a bank from transactions between the bank and its affiliates and limit the ability of a bank to transfer to its affiliates the subsidy arising from the bank's access to the Federal safety net (i.e., lower cost insured deposits, the payment system, and the discount window).[2] The statute and rule accomplish these purposes by imposing quantitative and qualitative limits on the ability of a bank to extend credit to, or engage in certain other transactions with, an affiliate. Transactions between a bank and a nonaffiliate that benefit an affiliate of the bank are covered by the statute and regulation as well, through the well-established "attribution" principle. However, certain transactions that generally do not expose a bank to undue risk or abuse the safety net are exempted from coverage under Regulation W.

The Gramm-Leach-Bliley Act (GLBA) increased the range of affiliations permitted to banking organizations. A key premise of GLBA was that sections 23A and 23B would limit the risk to depository institutions from these broader affiliations and eliminate the need for extensive prior review by the bank regulatory agencies. Given the enhanced role of sections 23A and 23B in risk management after GLBA, it is essential that examiners and other supervisory staff review intercompany transactions for compliance with the statutes and Regulation W. Reviews for compliance with the affiliate transaction rules should be frequent and rigorous, and any violations or potential violations should be resolved quickly.

A summary of significant issues addressed in the rule follows. The attached **appendix** provides a comprehensive review of the rule.

Significant Issues Addressed in Regulation W

Regulation W includes 70 years' worth of interpretive guidance furnished by the Board and its staff concerning statutory requirements that are fairly brief, but extremely complex in application. The following summarizes how the Board resolved nine significant issues addressed by the final rule.

1. Derivatives. The final rule (i) provides that derivative transactions between banks and their affiliates are subject to the market terms requirement of section 23B, and (ii) requires banks to adopt policies and procedures to manage the credit exposure arising from their derivative transactions with affiliates. The final rule does not subject credit exposure arising from bank-affiliate derivatives to the quantitative limits and collateral requirements of section 23A. The final rule also provides that credit derivatives between a bank and a nonaffiliate in which the bank protects the nonaffiliate from a default on, or decline in value of, an obligation of an affiliate of the bank are covered transactions under section 23A.

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

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

3. Financial Subsidiaries. The final rule provides that financial subsidiaries of a bank are affiliates of the bank. Thus, under the final rule, transactions between a bank and its financial subsidiary, as well as other affiliates, are subject to the requirements of sections 23A and 23B.

In addition to transactions between a bank and its financial subsidiary, certain transactions between an affiliate of a bank and a financial subsidiary of the bank are subject to sections 23A and 23B. Any purchase of, or investment in, the securities of a financial subsidiary of a bank by an affiliate of the bank is treated as a purchase of, or investment in, such securities by the bank. An extension of credit to a financial subsidiary of a bank by an affiliate of the bank is treated as an extension of credit by the bank if the extension of credit is treated as regulatory capital of the financial subsidiary. Other extensions of credit to a financial subsidiary of a bank by an affiliate of the bank may be treated as an extension of credit by the bank to the financial subsidiary if the Board determines, on a case-by-case basis, that such treatment is necessary or appropriate to prevent evasions of the Federal Reserve Act or GLBA.

The final rule, consistent with the law, defines a financial subsidiary as any subsidiary of a national or state chartered bank that engages in an activity not permissible for national banks to conduct directly. The final rule, however, exempts insurance agency subsidiaries of national and state chartered banks from the definition of financial subsidiary because these subsidiaries usually require little funding from their parent bank and generally do not pose a substantial threat to bank safety and soundness. In addition, the final rule exempts subsidiaries of a state chartered bank that engage only in (i) activities permissible for the state chartered bank to conduct directly, or (ii) activities they were lawfully conducting before issuance of the final rule (a grandfather provision for existing subsidiaries).

4. General Purpose Credit Card Exemption. The final rule exempts from section 23A extensions of credit by a bank under a general purpose credit card where the

borrower uses the credit to purchase goods or services from an affiliate of the bank. The final rule defines a general purpose credit card as a credit card issued by a bank that is widely accepted by merchants (such as a Visa card or Mastercard) so long as less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the bank.

The final rule generally exempts from the 25 percent test any bank that does not have nonfinancial affiliates, because banks with retail commercial affiliates typically are the banks whose credit cards are used substantially to purchase goods or services from affiliates of the banks. The final rule also exempts from the 25 percent test any widely accepted credit card if the issuer bank can establish to the Board's satisfaction that a minimal percentage of purchases with the card would be purchases from an affiliate of the bank.

5. <u>Foreign Banks</u>. For competitive equity reasons, the final rule applies sections 23A and 23B to transactions between the U.S. branches and agencies of a foreign bank and affiliates of the foreign bank engaged in the United States in several new GLBA activities, including securities underwriting and dealing, insurance underwriting, merchant banking, and insurance company investment. The regulation does <u>not</u> apply sections 23A or 23B to transactions between a U.S. branch or agency of a foreign bank and any other type of affiliate (for example, foreign affiliates or U.S. affiliates engaged in pre-GLBA nonbanking activities), or to transactions between the foreign bank's non-U.S. offices and its U.S. nonbank affiliates. This approach is consistent with the Board's previous application of sections 23A and 23B to section 20 affiliates of foreign banks before GLBA and securities and merchant banking affiliates of foreign banks after GLBA. Of course, sections 23A and 23B and Regulation W apply to a U.S. *bank* subsidiary of a foreign bank in the same manner and to the same extent as they would apply to any other U.S. bank.

6. <u>Section 250.250 Exemption</u>. Since 1974, a bank's purchase of loans from an affiliate has not been subject to section 23A if (i) the bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes the loan, and (ii) the bank commits to purchase the loan prior to the affiliate making the loan (the "250.250 exemption"). The purpose of the exemption was to allow a bank to take advantage of an investment opportunity and not to alleviate the funding needs of an affiliate. By the 1990s, however, some banks were using this exemption to provide nearly all their non-bank lending affiliates' funding. In 1995, to ensure that banks used the 250.250 exemption consistently with its original purpose, Board staff opined that the exemption was not available to any bank whose loan purchases from an affiliate represented more than 50 percent of the loans made by the affiliate.

The final rule retains the 50 percent test as a general matter but allows the bank's primary federal regulator to reduce the 50 percent threshold prospectively, on a case-by-case basis, if appropriate to protect the safety and soundness of the bank. Concurrent with the adoption of the final Regulation W, the Board is seeking comment on a proposed rule that would limit a bank's purchases of extensions of credit from an affiliate under the exemption to 100 percent of the bank's capital stock and surplus.

7. <u>Affiliated mutual funds</u>. The final rule includes an exemption for loans by a bank to a third party secured by securities issued by a mutual fund affiliate of the bank (subject to a number of conditions).

8. <u>Corporate reorganizations</u>. The final rule contains an exemption that would

permit a banking organization to engage more expeditiously in internal reorganization transactions involving a bank's purchase of assets from an affiliate (subject to a number of conditions, including those that the Board traditionally has imposed when granting case-by-case exemptions for such transactions).

9. Valuation rules. The final rule contains new valuation rules for a bank's investments in, and acquisitions of, affiliates.

Reserve Banks should distribute this letter and the attached review of Regulation W to the domestic and foreign banking organizations supervised by the Federal Reserve. Reserve Banks should also ensure that all central points of contact, examiners, and other staff involved in the supervision of banking organizations' lending and investing activities review this SR letter, the attached guidance, and Regulation W, and focus their supervisory activities accordingly.

Should you have any questions concerning this SR letter, please direct them to an appropriate individual noted below. General policy questions should be directed to Michael G. Martinson, Associate Director (202-452-3640), or Molly S. Wassom, Associate Director (202-452-2305). Questions concerning applications-related matters should be directed to Betsy Cross, Deputy Associate Director (202-452-2574), or Katie Cox, Supervisory Financial Analyst (202-452- 2721). All other supervision-related questions should be directed to Mary Frances Monroe, Senior Supervisory Financial Analyst (202-452-5231), or Michael J. Schoenfeld, Senior Supervisory Financial Analyst (202-452-2836). Questions regarding legal interpretations should be directed to Pamela G. Nardolilli, Senior Counsel (202-452-3289), or Mark E. Van Der Weide, Counsel (202-452-2263).

Richard Spillenkothen
Director

Attachment

Note:

1. 67 FR 76560, December 12, 2002. The text of the regulation is contained on the Board's public website at **http://www.federalreserve.gov/boarddocs/press/bcreg/2002/20021127/attachment1.pdf**. Many of the Board's interpretations of, and staff opinions on, sections 23A and 23B have been incorporated into Regulation W.

2. For ease of reference, this SR letter refers to "banks," but insured savings associations are also subject to sections 23A and 23B as if they are banks.

Appendix
Comprehensive Review of Regulation W

Overview of the Statute

Overview of Section 23A. Section 23A prohibits a bank from initiating a "covered transaction" with an affiliate if, after the transaction, (i) the aggregate amount of the bank's covered transactions with that particular affiliate would exceed 10 percent of the bank's capital stock and surplus, or (ii) the aggregate amount of the bank's covered transactions with all affiliates would exceed 20 percent of the bank's capital stock and surplus. Covered transactions include loans and other extensions of credit to an affiliate, investments in the securities of an affiliate, purchases of assets from an affiliate, and certain other transactions that expose the bank to the risks of its affiliates. A bank's capital stock and surplus is defined in section 223.3(d) of Regulation W as the sum of the bank's tier 1 and tier 2 capital under the risk-based capital guidelines, plus the balance of the allowance for loan and lease losses not included in tier 2 capital, based on the bank's most recent Call Report. The amount of any investment by the bank in a financial subsidiary that counts as a covered transaction and is required to be deducted from regulatory capital is added back for purposes of calculating capital stock and surplus for purposes of section 23A.

Section 23A requires all covered transactions between a bank and its affiliate to be on terms and conditions consistent with safe and sound banking practices ("Safety and Soundness Requirement"). Although the statute contains various exemptions, the Safety and Soundness Requirement must always be met. Section 23A prohibits a bank from purchasing a low-quality asset from an affiliate. Section 223.3(u) of Regulation W defines a low-quality asset to include an asset that is classified or treated as "special mention" or "other transfer risk problems" in an examination report or pursuant to the bank's or the affiliate's own internal asset classification system, an asset in a non-accrual status, or an asset on which payments of principal and interest are more than 30 days past due. In addition, an asset whose terms have been renegotiated or compromised as a result of the obligor's deteriorating financial condition, and any asset acquired through foreclosure, repossession, or otherwise in satisfaction of a debt previously contracted that has not been satisfactorily reviewed in an examination or inspection, are included within the definition of a "low-quality asset."

Extensions of credit to an affiliate and guarantees, letters of credit, and acceptances issued on behalf of an affiliate ("credit transactions") must be secured by a statutorily defined amount of collateral, ranging from 100 to 130 percent of the covered transaction amount. Securities issued by an affiliate and low-quality assets are not acceptable collateral for any credit transaction with an affiliate. In addition, the attribution rule provides that any transaction by a bank with any person is deemed to be an affiliate transaction subject to section 23A to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate.

Overview of Section 23B. Section 23B requires that certain transactions, including all covered transactions, be on market terms and conditions ("Market Terms Requirement"). In addition to covered transactions, the Market Terms Requirement applies to: (i) any sale of assets by the bank to an affiliate; (ii) any payment of money or furnishing of services by the bank to an

affiliate; (iii) any transaction in which an affiliate acts as agent or broker for the bank or any other person if the bank is a participant in the transaction; and (iv) any transaction by the bank with a third party if an affiliate has a financial interest in the third party or an affiliate is a participant in the transaction. In the absence of comparable transactions for identifying market terms, the bank must use terms, including credit standards that are at least as favorable to the bank as those that would be offered in good faith to nonaffiliated companies.

Determining Whether Regulation W Applies

Two initial questions need to be answered in determining whether a transaction is subject to Regulation W. The first is whether the transaction is between a bank and an "affiliate" of the bank. The second is whether the transaction is a "covered transaction."

Affiliate Definition. Regulation W applies to covered transactions between a bank and an affiliate of the bank.

The definition of an affiliate for purposes of Regulation W is set forth in section 223.2. The definition is broad, and includes:

- Any company that controls the bank;
- Any company that is controlled by a company that controls the bank;
- Any company 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;
- Any company in which a majority of its directors, trustees, or general partners (or individuals exercising similar functions) constitute a majority of the persons holding any such office with the bank or any company that controls the bank;
- 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;
- Any registered investment company for which the bank or any affiliate of the bank serves as an investment adviser;
- Any unregistered investment fund for which the bank or any affiliate of the bank serves as an investment adviser, if the bank and its affiliates own or control in the aggregate more than 5 percent of any class of voting securities or more than 5 percent of the equity capital of the fund[1];

[1] Many private equity funds, foreign investment funds, and commodities funds that currently escape treatment as an affiliate because they are not registered under the Investment Company Act of 1940 ("1940 Act") are covered under this definition. 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 an investment company registered with the SEC under the 1940 Act. The Board also believes that investment funds organized outside of the United States for which a bank or an affiliate serves as investment adviser are affiliates of the bank for purposes of section 23A.

- An insured depository institution[2] that is a subsidiary of the bank;
- A financial subsidiary[3] of the bank;
- Any subsidiary of the bank that is an employee stock option plan or similar entity established for the benefit of the shareholders, partners, members, or employees of the bank or an affiliate of the bank;
- Any subsidiary of the bank, if affiliates (other than insured depository institution affiliates) or controlling shareholders of the bank also control the subsidiary through a non-bank chain of ownership[4];
- Subject to certain safe harbors[5], any portfolio company in which a holding company of the bank owns or controls, directly or indirectly, or through one or more other persons, 15 percent or more of the equity capital of the company under the merchant banking or insurance company investment authority of GLBA;
- Any partnership for which the bank or any affiliate of the bank serves as general partner or for which the bank or affiliate causes any director, officer, or employee to serve as general partner;
- Any subsidiary of an affiliate of the bank; and
- A "catch-all" provision for any company that the Board or other appropriate federal banking agency determines by regulation or order to have a relationship with the bank or an affiliate of the bank such that covered transactions by the bank with the company may have a detrimental effect on the bank.

Regulation W continues the traditional section 23A exclusions from the definition of affiliate for companies acquired as a result of rights acquired out of a bona fide debt previously contracted and companies engaged solely in: (i) holding bank premises; (ii) conducting a safe deposit business; or (iii) holding U.S. government obligations (as defined in the Board's Regulation A).

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[2] An insured depository institution includes an operating subsidiary of the institution. Uninsured depository institution subsidiaries generally are excluded from the definition of an affiliate.

[3] See "Special Rules and Exemptions under Regulation W – Special Rules for Financial Subsidiaries" for exemptions from the definition of financial subsidiary.

[4] For example, if a bank owns 50 percent of a joint venture company and an affiliate of the bank owns the remaining 50 percent through a chain of ownership not running through the bank, the company is deemed an affiliate, and not a subsidiary, of the bank for purposes of Regulation W.

[5] These safe harbors are consistent with the Board's and Treasury's merchant banking rule and include situations: (i) where no representative of the holding company serves as a director of the portfolio company; (ii) where an independent third party owns a greater percentage of the equity capital of the portfolio company than does the holding company, and no more than one representative of the holding company serves as director of the portfolio company; and (iii) where an independent third party owns more than 50 percent of the voting shares of the portfolio company, and representatives of the holding company do not constitute a majority of the directors of the portfolio company.

The Board decided to defer a determination as to whether special purpose entities ("SPEs") associated with a bank should in any circumstances be deemed affiliates of the bank, in light of the complexity of this issue and pending FASB proposals on the consolidation of SPEs. However, a company sponsored and advised on a contractual basis by a bank or an affiliate of the bank is an affiliate under section 23A and Regulation W.

In addition to section 23A's definition of control, section 223.3(g) of Regulation W includes two control provisions that are similar to presumptions contained in Regulation Y. First, a company is deemed to control securities, assets, or other ownership interests controlled by a subsidiary of the company. Second, a company that controls instruments that are convertible, at the option of the holder, into securities, will be deemed to hold those securities. In addition, under Regulation W, a rebuttable presumption of control arises when a company owns or controls more than 25 percent of the total equity of a second company.

If a bank proposes to engage in a transaction with an affiliate, the bank must determine whether the transaction would be a covered transaction. If the bank proposes to engage in a covered transaction with an affiliate, the provisions of Regulation W apply.

Definition of Covered Transaction. Under section 223.3(h) of Regulation W, a covered transaction includes:

- An extension of credit to an affiliate;
- A purchase of, or investment in, a security issued by an affiliate;
- A purchase of an asset from an affiliate, including an asset subject to recourse or an agreement to repurchase;
- The acceptance of a security issued by an affiliate as collateral for an extension of credit to any person or company; and
- The issuance of a guarantee[6], acceptance, or letter of credit, including: an endorsement or standby letter of credit, on behalf of an affiliate[7]; a confirmation of a letter of credit issued by an affiliate; and a cross-affiliate netting arrangement.

An extension of credit to an affiliate is broadly defined in section 223.3(o) of Regulation W as the making or renewal of a loan, the granting of a line of credit, or the extending of credit in any manner whatsoever[8], including on an intraday basis, to an affiliate. A bank's purchase of

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[6] A guarantee by a bank on behalf of an affiliate does *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.

[7] Regulation W clarifies that the section 23B prohibition on a bank publishing an advertisement or entering into an agreement stating or suggesting that the bank will be in any way responsible for the obligations of its affiliates does not preclude the bank from issuing a guarantee, acceptance, or letter of credit on behalf of an affiliate in accordance with section 23A.

[8] Including: any advance to an affiliate by means of an overdraft, cash item, or otherwise; a sale of federal funds to an affiliate; a lease that is the functional equivalent of an extension of credit to

a debt security issued by an affiliate is an extension of credit by the bank to the affiliate for purposes of section 23A and Regulation W, and must, among other things, be collateralized in accordance with the statute and the rule.

Cross-affiliate netting arrangements are defined in section 223.3(j) of Regulation W as arrangements among a bank, one or more affiliates of the bank, and one or more nonaffiliates, where the nonaffiliate is permitted to deduct obligations of the affiliate to the nonaffiliate in settling its obligations to the bank, or a bank is required or permitted to add affiliate obligations to a nonaffiliate when determining the bank's total obligations to the nonaffiliate. These arrangements expose a bank to the credit risk of its affiliate because the bank may become obligated to assume the obligation of the affiliate.

"Keepwell" agreements, under which a bank commits to maintain the capital levels or solvency of an affiliate, also are considered guarantees for purposes of section 23A and Regulation W. The credit risk incurred by the bank in such arrangements is similar to the risk incurred by the bank when it issues a guarantee on behalf of an affiliate.

Valuation and Timing Rules under Regulation W

Sections 223.21 through 223.24 of Regulation W set forth valuation and timing rules that are designed to determine the amount of a covered transaction subject to the quantitative limitations and collateral requirements of the rule and the time at which a transaction becomes subject to Regulation W limitations and requirements. Special valuation rules apply to financial subsidiary affiliates of a bank. See "Special Rules and Exemptions under Regulation W – Special Rules for Financial Subsidiaries."

Valuation Rules for Credit Transactions. Credit transactions with affiliates generally are valued at the *greater* of: (i) the principal amount of the transaction; (ii) the amount owed by the affiliate to the bank under the transaction; or (iii) the sum of the amount provided to, or on behalf of, the affiliate in the transaction and any additional amount the bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.

The value of a loan to an affiliate purchased by the bank from a nonaffiliate is the total amount of consideration given by the bank in exchange for the loan and any additional amount the bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.

Although a bank's purchase of, or investment in, a debt security issued by an affiliate is considered an extension of credit to the affiliate, these transactions are not valued like other extensions of credit. Purchases of, or investments in, securities issued by an affiliate are valued at the *greater* of the bank's purchase price or the carrying value of the securities.

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an affiliate; an acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or debt securities, of an affiliate; any increase in the amount of, extension of the maturity of, or adjustment to the interest rate term or other material term of an extension of credit to an affiliate; and any other similar transaction as a result of which an affiliate becomes obligated to pay money or its equivalent.

Special Timing Rules for Credit Transactions. A bank is deemed to enter into a credit transaction with an affiliate at the time during the day that the bank becomes legally obligated to enter into the transaction, not at the end of the day on which the loan agreement is signed or the loan is funded. Credit transactions with nonaffiliates generally become covered transactions if and when the nonaffiliate becomes an affiliate of the bank. If the nonaffiliate becomes an affiliate within one year after the bank has entered into the credit transaction with it, the bank must ensure that the collateral requirements of Regulation W are met "promptly" *after* the nonaffiliate becomes an affiliate. In all cases, the transaction must meet the Market Terms Requirement.

The leeway provided by the "promptly" standard is not available if the credit transaction is made in contemplation of the nonaffiliate becoming an affiliate of the bank. Under section 223.3(t) of Regulation W, a transaction is presumed to be in contemplation of a nonaffiliate becoming an affiliate of the bank if the bank enters into the transaction after the execution of, or commencement of negotiations designed to result in, an agreement under which the nonaffiliate would become an affiliate. If the credit transaction is in contemplation of a nonaffiliate becoming an affiliate of the bank, the bank must ensure that the rule's quantitative limitations and collateral requirements would be met at the time the nonaffiliate becomes an affiliate.

Loans Secured by Affiliate Securities. Loans by a bank to a third party that are secured exclusively by affiliate securities are valued at the *lesser* of: (i) the total amount of the extension of credit; and (ii) the fair market value of the pledged affiliate securities, if they have publicly available price quotes.

Loans by a bank to a third party that are secured by both affiliate and nonaffiliate securities are valued at the lesser of: (i) the total amount of the extension of credit, minus the fair market value of nonaffiliate collateral; and (ii) the fair market value of the pledged affiliate securities, if they have publicly available price quotes. Under this valuation rule, the maximum amount that the bank must count against Regulation W's quantitative limits is the difference between the full amount of the loan and the fair market value of the nonaffiliate collateral.

Securities of an eligible affiliated mutual fund are not considered securities issued by an affiliate for purposes of this valuation rule, subject to certain conditions designed to ensure liquidity and minimize the use of the exemption as a method of funding affiliates. Eligible affiliated mutual fund securities are securities issued by an open-end investment company registered with the SEC under the 1940 Act if:

- The securities have publicly available price quotes; and
- The bank and its affiliates do not own more than 5 percent of the fund's shares, excluding shares held in good faith in a fiduciary capacity[9].

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[9] Shares held by the bank or an affiliate of the bank in a fiduciary capacity for the benefit of the bank or affiliate, or the shareholders, employees, or subsidiaries of the bank or affiliate, are not eligible for this exclusion.

Furthermore, the bank may not exclude affiliated mutual fund securities if it knows or has reason to know that the proceeds of the extension of credit will be used to purchase the affiliated mutual fund shares serving as collateral or otherwise will be used to benefit an affiliate.

Valuation Rules for Purchases of Assets from an Affiliate. Purchases of assets by a bank from an affiliate generally are valued at the total consideration given, including liabilities assumed, by the bank in exchange for the asset. The value may be reduced after the purchase to reflect amortization or depreciation of the asset, consistent with GAAP.

Regulation W provides a special valuation rule for a bank's purchase of a line of credit or loan commitment from an affiliate. A bank must value such an asset at the purchase price paid, plus any additional amount that the bank is obligated to provide under the credit facility. Without this special rule, a company would be able to transfer substantial amounts of unfunded obligations to its affiliated bank without being subject to section 23A's quantitative limitations.

Valuation Rules for Purchases of or Investments in Affiliate Securities. As noted above, purchases of or investments in securities issued by an affiliate are valued at the *greater* of the bank's purchase price or carrying value of the securities. This approach reflects the risk of continuing exposure to an affiliate through an investment in securities, even if that investment was made at a price below the carrying value of the securities. On the other hand, if the carrying value of the investment declines below the purchase price as the affiliate's financial condition worsens, the rule limits the ability of the bank to provide additional funding as the affiliate approaches insolvency.

A bank may acquire securities of an affiliate in a transaction that results in the affiliate becoming an operating subsidiary of the bank. These transactions are treated as a purchase of assets and assumption of liabilities of an affiliate . The covered transaction amount for these transactions is the total amount of consideration given by the bank for the shares, plus the total liabilities of the transferred company.[10] The value of the covered transaction may be subsequently reduced to reflect amortization or depreciation of the assets of the transferred company consistent with GAAP, and sales of assets of the transferred company.

The Limitations and Requirements of Regulation W

Quantitative Limitations. A bank may not engage in a new covered transaction with an affiliate if the aggregate amount of covered transactions between the bank and the affiliate would be in excess of 10 percent of the bank's capital stock and surplus after consummation of the new transaction. Aggregate covered transactions between the bank and all affiliates are limited to 20 percent of the bank's capital stock and surplus.

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[10] In the past, the Board has considered these transactions to be covered transactions only to the extent that the transferred company has liabilities to another *affiliate* of the bank at the time of the transaction. Regulation W, on the other hand, treats these transactions as covered transactions to the extent that the transferred entity has obligations to *any* person.

Consistent with GLBA, transactions between a bank and a financial subsidiary of the bank are not subject to the 10 percent limitation. The exemption from the 10 percent limit applies to investments by the bank in its *own* financial subsidiaries. Investments by the bank in the financial subsidiaries of affiliated depository institutions are subject to the 10 percent limitation. Aggregate covered transactions with all financial subsidiaries and other affiliates of the bank are subject to the 20 percent limitation. Other provisions of Regulation W applicable to financial subsidiaries are discussed under "Special Rules and Exemptions under Regulation W – Special Rules for Financial Subsidiaries."

Consistent with existing interpretations of section 23A, Regulation W does not require the unwinding of transactions if a bank's capital declines such that the 10 or 20 percent quantitative limitation is exceeded. However, new transactions would be forbidden until the quantitative limits could be met.

Collateral Requirements. Any credit transaction between a bank and its affiliate must be secured with the statutorily required amount of collateral. Under section 223.14 of Regulation W:

- A credit transaction must be secured by collateral having a market value equal to at least:
    - 100 percent of the amount of the transaction if the collateral is:
        - obligations of the United States or its agencies;
        - obligations fully guaranteed by the United States or its agencies as to principal and interest;
        - notes, drafts, bills of exchange, or bankers' acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank; or
        - a segregated, earmarked deposit account with the bank that exists for the sole purpose of securing credit transactions between the member bank and its affiliates and is identified as such[11].
    - 110 percent of the amount of the transaction if the collateral is obligations of any State or political subdivision thereof.
    - 120 percent of the amount of the transaction if the collateral is other debt instruments, including loans or other receivables.
    - 130 percent of the amount of the transaction if the collateral is stock, leases, or other real or personal property.

- The following types of collateral are *ineligible* collateral under Regulation W:
    - Low-quality assets;
    - Securities issued by any affiliate;
    - Equity securities issued by the bank and debt securities issued by the bank that represent regulatory capital of the bank[12];

[11] This may be an omnibus deposit account for multiple affiliates and multiple covered transactions, provided that the account fully secures all such covered transactions.

- Intangible assets,[13] unless specifically approved by the Board,
- Guarantees, letters of credit, and similar instruments.

In addition, a bank must maintain a perfected security interest in collateral securing credit transactions. The security interest must be enforceable under applicable law, including in the event of bankruptcy or similar default. If the bank does not have a first priority security interest in the collateral, it must deduct from the value of the collateral the lesser of: (i) the amount of any security interest in the collateral that is senior to the bank's interest; or (ii) the amount of credit secured by the collateral that is senior to the bank's position. Any retired or amortized collateral must be replaced with additional eligible collateral over the life of the credit transaction.

Some transactions are exempt from the collateralization requirements. These include:

- An acceptance that is already fully secured either by attached documents[14] or other property with an ascertainable market value that is involved in the transaction;
- The unused portion of an extension of credit to an affiliate if the bank does not have any legal obligation to advance additional funds until required collateral is posted; and
- Purchases of affiliate debt securities by the bank from a nonaffiliate in a bona fide secondary market transaction.

Provisions Applicable to Foreign Banks

Section 223.61 of Regulation W applies sections 23A and 23B to transactions between a U.S. branch or agency of a foreign bank and affiliates of the branch or agency engaged directly in the United States in the following activities: full-scope securities underwriting and dealing; non-credit-related insurance underwriting; merchant banking; and insurance company investments.[15] Regulation W also applies 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 GLBA's merchant banking or insurance company investment authorities. Regulation W

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[12] If the bank were forced to foreclose on credit transactions with affiliates secured by bank-issued securities, the bank might be unwilling to liquidate the collateral promptly if its capital or share price would decline or if the liquidation would trigger a change in control.

[13] The definition of intangible assets includes but is not limited to, intangible assets for purposes of GAAP.

[14] A security agreement that references specific assets.

[15] The rule also applies to any subsidiary of an affiliate engaged in those activities. If these subsidiaries were not covered, the U.S. branch arguably could fund the foreign bank's U.S. operations outside of the scope of sections 23A and 23B and Regulation W by lending money to a subsidiary of the affiliate and having the subsidiary dividend or re-lend the funds to the affiliate.

does not apply to transactions between a U.S. branch or agency of a foreign bank and other affiliates or to transactions between the foreign bank's non-U.S. offices and its U.S. affiliates.

Special Rules and Exemptions under Regulation W

Special Rules for Derivatives Transactions. Banks enter into derivatives transactions with their affiliates most commonly to address the risk management needs of either the bank or the affiliate. Banks and their affiliates typically use each other as derivatives counterparties in order to maximize profits and manage risks within the consolidated organization.

GLBA required the Board to adopt by May 12, 2001, a final rule addressing the appropriate treatment of derivatives transactions with affiliates under section 23A. As an interim measure[16], the Board required banks to adopt policies and procedures to manage the credit exposure arising from such transactions and clarified that such transactions were subject to the market terms requirement of section 23B. Under section 23B, banks may engage in derivatives transactions with affiliates only on terms and under circumstances that are at least as favorable to the bank as those prevailing at the time for comparable transactions with nonaffiliates.

Since the adoption of the interim rule, Federal Reserve staff has reviewed the compliance with section 23B of a sampling of banks actively engaged in derivatives transactions with their affiliates. This survey revealed a number of compliance issues as a result of varying interpretations of the scope of section 23B as applied to derivatives transactions with affiliates. Some banks took the view that the most liberal terms granted to the bank's most highly rated nonaffiliate counterparties could be granted to bank affiliates. The preamble to Regulation W emphasizes that this treatment of affiliates is not appropriate.

Under section 223.33 of Regulation W, a bank must establish policies and procedures reasonably designed to manage the credit exposure arising from its derivatives transactions with each affiliate and all affiliates in the aggregate. Specifically, the policies and procedures must at a minimum provide for:

- Monitoring and controlling the credit exposure arising at any one time from the bank's derivatives transactions with each affiliate and all affiliates in the aggregate;
- Ensuring that the bank's derivatives transactions comply with the market terms requirement of section 23B. In particular, a bank must:
    - Have in place credit limits on its derivatives exposures to affiliates that are at least as strict as those imposed on unaffiliated companies engaged in similar businesses and substantially equivalent in size and credit quality;
    - Monitor its derivatives exposure to affiliates in a manner at least as rigorous as used to monitor exposure to comparable unaffiliated companies; and
    - Price, and require collateralization of, affiliate derivatives transactions in a way that is at least as favorable to the bank as pricing and collateralization of unaffiliated transactions.

[16] 66 FR 24229 (May 11, 2001).

Monitoring and controlling the credit exposure from derivatives transactions includes, at a minimum, imposing appropriate credit limits, mark-to-market requirements, and collateral requirements. The limits and requirements imposed by a bank should reflect the nature, volume, and complexity of its derivatives transactions, and should be approved by the board of directors of the bank or an appropriate board committee. Going forward, Board staff will consider the need for additional guidance on policies and procedures for derivatives transactions with affiliates.

Regulation W does not subject credit exposures arising from bank-affiliate derivatives to the quantitative limits and collateral requirements of section 23A. However, Regulation W treats as a covered transaction subject to section 23A credit derivative transactions between a bank and a nonaffiliate in which the bank protects the nonaffiliate from a default on, or decline in the value of, an obligation of an affiliate of the bank.[17] These transactions are the functional equivalent of a guarantee by the bank on behalf of the affiliate. Regulation W does not allow the bank to reduce its covered transaction amount for these transactions to reflect hedging transactions by the bank with third parties. However, the Board intends to interpret this provision so as to treat such a credit derivative as a covered transaction only to the extent that the derivative provides credit protection with respect to obligations of an affiliate of the bank.

The Board anticipates issuing regulations to address derivatives transactions that are the functional equivalent of a loan by a bank to an affiliate or the functional equivalent of a purchase of an asset by a bank from an affiliate. An obvious example of a loan-equivalent derivative would be the purchase of a deep-in-the-money option by a bank from an affiliate. An asset-purchase-equivalent derivative could be a credit default swap under which the bank agrees to compensate its affiliate for any default of a loan asset held by the affiliate.

Special Rules for Financial Subsidiaries. Regulation W treats financial subsidiaries of a bank as affiliates of the bank, in contrast to the general treatment of subsidiaries of a bank as nonaffiliates. A financial subsidiary is any subsidiary of a *national or state* bank that engages in activities (whether as principal or agent) not permissible for *national* banks to conduct directly.[18] Financial subsidiaries do not, however, include insurance agency subsidiaries, as they usually require little parent funding and generally do not pose safety and soundness concerns.

Regulation W also exempts from the definition of a financial subsidiary a subsidiary of a state bank that engages only in activities permissible for the state bank to conduct directly or activities lawfully conducted prior to December 12, 2002, the date of publication of final Regulation W. However, neither of these exemptions is available for a financial subsidiary of a state bank that engages in principal activities that GLBA requires a national bank to conduct in a financial subsidiary. For example, a subsidiary of a state bank that is underwriting and dealing in bank-ineligible securities would be a financial subsidiary.

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[17] Generally, the amount of the covered transaction would be the notional amount of the derivative.

[18] Regulation W does not address financial subsidiaries of thrifts, as subsidiaries of thrifts are subject to a number of statutory prudential requirements.

A bank's investment in securities issued by its own financial subsidiary is valued at the greater of: (i) the total amount of consideration given by the bank in exchange for the security; and (ii) the carrying value of the security as of the date of acquisition. The carrying value of the bank's investment for purposes of this valuation rule is not adjusted going forward for any earnings retained or losses incurred by the subsidiary after the bank's investment. If the financial subsidiary is consolidated with the bank under GAAP, the carrying value of the securities of the financial subsidiary shall be equal to the carrying value of the securities on the parent-only GAAP financial statements of the bank (adjusted so as not to reflect 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).

GLBA provides that any investment in the securities of a financial subsidiary of a bank by an affiliate of the bank is treated as an investment by the bank in such securities. In addition, under Regulation W, if an extension of credit to the financial subsidiary by an affiliate of the bank is treated as regulatory capital of the financial subsidiary, the extension of credit by the affiliate is attributed to the bank. Other extensions of credit to a bank's financial subsidiary by an affiliate of the bank may be treated as an extension of credit by the bank, if the Board determines such treatment to be appropriate.

Exemptions from the Attribution Rule. Regulation W provides certain exemptions from the general rule that treats a transaction with any person as an affiliate transaction to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate. Notwithstanding these exemptions, these transactions are subject to the Safety and Soundness and Market Terms Requirements of Regulation W.

Exemption from the Attribution Rule for General Purpose Credit Cards. Section 223.16(c) of Regulation W exempts from the attribution rule an extension of credit to a nonaffiliate if (i) proceeds are used to purchase goods and services from an affiliate of the bank, and (ii) the extension of credit is made pursuant to and consistent with the conditions of a general purpose credit card. A general purpose credit card means a credit card issued by the bank that is widely accepted by merchants that are not affiliates of the bank if less than 25 percent of the total value of products and services purchased with the card are purchases of products and services from an affiliate of the bank. The funding benefit received by the bank's affiliate from the use of general purpose credit cards by unaffiliated borrowers is likely to be minimal, and a bank's decision to issue a general purpose credit card and extend credit pursuant to the card likely would be based on independent credit standards unrelated to possible affiliate transactions.

A bank has a number of methods for demonstrating that its credit card meets the 25 percent test.

- A bank that has no commercial affiliates would satisfy the test if it has no reason to believe it would fail. Such a bank would not be required to establish systems to compute compliance with the test.
- A bank with commercial affiliates can satisfy the test by:

- Presenting information to the Board demonstrating that the card should always comply with the 25 percent test;[19] or
- Establishing systems to compute compliance with the test on a monthly basis.

The computation of monthly compliance with the 25 percent test is based on cardholder purchases over a rolling average of the preceding 12 months. Section 223.16(c)(4)(iv) of Regulation W provides an example of computing compliance with the 25 percent test.

Banks that fall out of compliance with the 25 percent test generally have a three-month grace period to return to compliance before they become subject to section 23A. Moreover, banks that become subject to section 23A are eligible to re-test and regain the exemption the following month.

Exemption from the Attribution Rule for Agency Transactions. Under section 223.16(b) of Regulation W, an extension of credit by a bank to a nonaffiliate is not attributed to an affiliate of the bank if the proceeds are used to purchase an asset through an affiliate that is acting exclusively as an agent or broker in the transaction, and the asset is not issued, underwritten, or sold as principal by any affiliate of the bank. However, the receipt of a fee, commission, or other compensation by the affiliate agent or broker is subject to the Market Terms Requirement.

Exemption from the Attribution Rule for Riskless Principal Transactions. Under section 223.16(c) of Regulation W, an extension of credit by a bank to a nonaffiliate is not attributed to an affiliate of the bank if:

- The proceeds of the extension of credit are used to purchase a security through a SEC-registered broker-dealer affiliate of the bank, and the affiliate is acting exclusively as a riskless principal in the transaction;
- The security purchased is not issued, underwritten or sold as principal (other than as riskless principal) by an affiliate of the bank; and
- Any mark-up or other compensation received by the affiliate is substantially the same as, or lower than, those prevailing at the time for comparable transactions with or involving nonaffiliates.

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

Exemption from the Attribution Rule for Pre-Existing Lines of Credit. Section 223.16(c)(3) of Regulation W provides that an extension of credit by a bank to a nonaffiliate is not attributed to an affiliate of the bank from which the nonaffiliate purchases securities, provided that the extension of credit is made pursuant to, and consistent with any conditions imposed in, a pre-existing line of credit that was not established in contemplation of the purchase of securities from or through an affiliate of the bank.

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[19] For example, by demonstrating that aggregate affiliate sales do not approach a level close to 25 percent of total sales under the card.

Exemptions from the Quantitative Limits and Collateral Requirements. Certain transactions are exempt from the quantitative limits and collateral requirements of Regulation W. These transactions are subject, however, to the Safety and Soundness Requirement and the prohibition on the purchase of a low-quality asset from an affiliate.

Sister Bank Transactions. Transactions between a bank and an insured depository institution, 80 percent or more of the voting securities of which are controlled by the holding company that also controls 80 percent or more of the voting securities of the bank are exempt from the quantitative limits and collateral requirements of Regulation W. In addition, transactions between a bank and an insured depository institution where the bank controls 80 percent or more of the voting securities of the depository institution, or the depository institution controls 80 percent or more of the voting securities of the bank, are exempt from the quantitative limits and collateral requirements.

Exemption for Purchases of Marketable Securities. Purchases of marketable securities from a securities affiliate that is not a principal underwriter of the issue are exempt from the quantitative limitations and collateral requirements of Regulation W, if:

- The securities affiliate is a SEC-registered broker-dealer;
- The security has a ready market;
- The security is eligible for a state member bank to purchase directly[20] and the bank records the transaction as a purchase of a security for Call Report purposes;
- The security is not a low-quality asset or issued by an affiliate of the bank;
- The bank does not purchase the security during or within 30 days of an underwriting, unless the security is purchased as part of an issue of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies;
- The price of the security is quoted routinely on an unaffiliated electronic, real-time service, the price paid by the bank is at or below the current quotation, and the size of the transaction does not cast material doubt on the appropriateness of relying on the quotation; and
- The bank maintains, for two years, appropriate documentation in support of reliance on the exemption.

Any such transaction must comply with the Market Terms Requirement.

Exemption for Internal Corporate Reorganizations. Section 223.41(d) of Regulation W provides an exemption from the rule's quantitative limits and collateral requirements for certain internal corporate reorganizations. Under this exemption, a bank is permitted to purchase assets (other than low-quality assets) from an affiliate if the following conditions are met:

[20] Including securities permissible for a state member bank to purchase and hold as a hedge of permissible customer-driven equity derivatives transactions (even if not permissible under a state member bank's general investment powers).

- The asset purchase is part of an internal corporate reorganization of a holding company that involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate;
- The bank holding company provides the Board with contemporaneous notice of the transaction and commits to the Board to make the bank whole, for a two-year period, for any transferred assets that become low-quality assets;
- A majority of the bank's directors reviews and approves the transaction prior to consummation;
- The section 23A value of the covered transaction is less than 10 percent of the bank's capital stock and surplus (or up to 25 percent with the approval of the appropriate federal banking agency); and
- The bank's holding company and each of its subsidiary depository institutions are well capitalized and well managed and remain well capitalized upon consummation of the transaction.

Any such transaction must comply with the Market Terms Requirement.

Exemption for Non-Recourse Loan Purchases. Section 223.41(c) of Regulation W provides an exemption from the rule's quantitative limits and collateral requirements for purchases of loans by a bank from an affiliated insured depository institution on a non-recourse basis.

<u>Exemptions from the Quantitative Limitations, Collateral Requirements, and Low-Quality Asset Purchase Prohibition</u>. A number of other transactions are exempt from the quantitative limitations, collateral requirements, and prohibition on the purchase of a low-quality asset contained in Regulation W. Each of these transactions must comply with the Safety and Soundness Requirement.

Exemption for Intraday Credit to Affiliates. GLBA required the Board to adopt, by May 12, 2001, a final rule to address under section 23A credit exposure arising from intraday extensions of credit by banks to their affiliates. Similar to the Board's approach to bank-affiliate derivatives transactions, as an interim measure, the Board required banks to adopt policies and procedures reasonably designed to manage the credit exposure from these transactions, and clarified that the Market Terms Requirement applies to these transactions.

Section 223.42(l) of Regulation W provides that intraday extensions of credit to an affiliate by a bank are exempt from the quantitative limits and collateral requirements contained in the rule, provided that:

- The bank establishes and maintains policies and procedures reasonably designed to manage in a safe and sound manner the credit exposure arising from the bank's intraday extensions of credit to affiliates, including policies and procedures that address monitoring and controlling the credit exposure to affiliates from intraday credit and ensure compliance with the Market Terms Requirement.
- The bank has no reason to believe that the affiliate will be unable to repay the extension of credit in accordance with its terms.

Monitoring and controlling the credit exposure from intraday extensions of credit include, at a minimum, imposing appropriate credit limits (on a per-affiliate and aggregate basis) and collateral requirements. The limits and requirements imposed by a bank should reflect the volume of intraday credit transactions and the reasons for those transactions. Limits and requirements on intraday credit transactions should be approved by the board of directors of the bank or an appropriate board committee. Going forward, Board staff will consider the need for additional guidance on policies and procedures for intraday extensions of credit to affiliates.

The final rule also defines an intraday credit extension by a bank to an affiliate as an extension of credit by a bank to an affiliate that the bank expects to be repaid, sold, or terminated, or to qualify for a complete exemption under the rule, by the end of the day. Importantly, final Regulation W extends the section 23A intraday exemption to all intraday extensions of credit to affiliates, and does not limit the exemption, as proposed Regulation W would have done, to credit extensions relating to clearing and settlement. Board staff determined that the limited potential for, and history of, abuse of intraday credit to affiliates, and the significant burden on banks of subjecting some intraday credit transactions to section 23A, outweighed regulatory benefits.

Provided no other exemption in Regulation W applies, any intraday credit outstanding as of the end of the bank's U.S. business day will be treated as a non-exempt covered transaction at such time.

Exemption for Riskless Principal Transactions. Section 223.42(m) of Regulation W exempts from the quantitative limits, collateral requirements, and prohibition on the purchase of a low-quality asset the purchase of securities by a bank from its securities affiliate if the bank or the affiliate is acting exclusively in a riskless principal capacity and the security is not issued, underwritten, or sold as principal (other than as riskless principal) by any affiliate of the bank. All such transactions are subject to the Safety and Soundness and Market Terms Requirements of Regulation W.

Exemption for Purchases of Municipal Securities from a Securities Affiliate. Purchases of municipal securities from a securities affiliate are exempt from the quantitative limitations, collateral requirements, and prohibition on the purchase of a low-quality asset of Regulation W, if:

- The securities affiliate is a SEC-registered broker-dealer;
- The security is rated by a nationally recognized statistical rating organization or is part of an issue of securities that does not exceed $25 million;
- The security is eligible for purchase by a state member bank and the bank records the transaction as a purchase of a security for Call Report purposes; and
- One of the following applies:
  - The security price is quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks, the price paid by the bank is at or below the current market quotation, and the size of the

transaction does not cast doubt on the appropriateness of relying on the quotation, or
- The price paid can be verified by reference to two or more actual, current price quotes from unaffiliated broker-dealers on the same or a similar security, based on a similarly sized transaction, and the bank does not pay a price that exceeds the average of the price quotes; or
- The price paid can be verified by reference to the written summary of aggregate prices and par values provided to syndicate members by the syndicate manager, and the bank purchases the security during the underwriting period at a price at or below that indicated in the summary and retains a copy of the summary in its books and records for a period of three years.

Any such transaction must comply with the Market Terms Requirement.

Exemption for Nonrecourse Loan Purchases. Nonrecourse purchases by a bank from an affiliate of extensions of credit made by the affiliate are exempt from the quantitative limitations, collateral requirements, and prohibition on the purchase of a low-quality asset contained in Regulation W if:

- The extension of credit was originated by the affiliate;
- The bank made an independent evaluation of the creditworthiness of the borrower and committed to purchase the extension of credit before the affiliate made or committed to make the extension of credit;
- The bank does not make blanket advance commitments to purchase loans from the affiliate; and
- The dollar amount of all purchases over the preceding 12 months by the bank and its insured depository institution affiliates does not represent more than 50 percent of the dollar amount of all extensions of credit by the affiliate during such period. The appropriate federal banking agency may impose a lower percentage threshold in its discretion.

Additional Transactions Exempt from the Quantitative Limitations, Collateral Requirements, and Low-Quality Asset Purchase Prohibition.

- *Purchases of Loans Subject to Repurchase*. Purchases from an affiliate of extensions of credit originated by the bank and sold to the affiliate subject to a repurchase agreement or with recourse.

- *Purchases of Securities of a Servicing Affiliate*. Purchasing a security issued by any company engaged solely in providing services to a bank or bank holding company under section 4(c)(1) of the BHCA.

- *Purchases of Liquid Assets*. Purchasing an asset, other than an affiliate-issued security, having a readily identifiable and publicly available market quotation[21] at a price at or below the current market quotation.

- *Purchases of Assets by a Newly Formed Bank*. Purchases of assets by a newly formed bank, as approved in writing by the appropriate federal banking agency.

- *Mergers and Acquisitions*. Mergers or acquisitions, or purchase and assumption transactions, between a bank and an affiliated depository institution or U.S. branch or agency of an affiliated foreign bank that has been approved by the responsible federal banking agency under the Bank Merger Act.

- *Correspondent Banking Deposits*. Making a deposit in an affiliated depository institution or affiliated foreign bank that represents an on-going working balance maintained in the ordinary course of correspondent business.

- *Giving Credit for Uncollected Items*. Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business.

- *Transactions Secured by Cash or U.S. Government Securities*. A credit transaction with an affiliate to the extent that the transaction is and remains secured by obligations of the United States or its agencies, obligations fully guaranteed by the United States or its agencies as to principal and interest, or a segregated, earmarked deposit account with the bank that is for the sole purpose of securing credit transactions between the bank and its affiliates and is identified as such.

Exemption from the Prohibition on Purchases of Low-Quality Assets. The general prohibition on purchases of low-quality assets from affiliates does not apply to certain situations in which a bank seeks to protect its interest in a distressed loan participation. Under section 223.15(b) of Regulation W, the prohibition 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 affiliate[22] of the bank, if:

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

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[21] An asset has a readily identifiable and publicly available market quotation if the asset's price is quoted routinely in a widely disseminated publication that is readily available to the general public. The asset need not be exchange-traded. Internet website quotes are not sufficient, by themselves, to meet the "widely disseminated" standard.

[22] *Any* affiliate of the bank, not only insured depository institution affiliates, as set forth in the proposed rule.

- The renewal or extension of additional credit is approved as necessary to protect the bank's investment by the board of directors of the bank[23];
- The participating bank's share of the renewal or extension of additional credit does not exceed its proportional share of the original transaction by more than 5 percent, unless the bank obtains the written approval of its appropriate federal banking agency; and
- The bank provides its appropriate federal banking agency with written notice of the renewal or extension of additional credit within 20 days.

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[23] If the affiliate originating the credit is a depository institution, the approval of the renewal or extension of additional credit may be provided by an executive committee of the board, or one or more senior management officials of the bank under, and in compliance with, board-approved standards (so long as such standards and renewals or extensions approved under such standards are periodically reviewed by the board).