At Circular 7781a

FEDERAL RESERVE BANK
OF NEW YORK

Transactions Between Subsidiaries of Bank Holding Companies

December 26, 1975

To the Chief Executive Officer of Each Bank Holding Company in the Second Federal Reserve District:

Following is the text of a letter from the Secretary of the Board of Governors of the Federal Reserve System that the Board of Governors has asked us to transmit to the chief executive officers of all bank holding companies in this District:

The purpose of this letter is to inform you of the Board's concern with respect to situations in which a bank holding company's banking subsidiary may have been exposed to adverse consequences because of transactions with the company's nonbanking subsidiaries. Such a situation would be one in which a banking subsidiary of a bank holding company has purchased assets of poor quality from a mortgage banking or consumer finance subsidiary of the holding company at prices significantly higher than they would bring in an "arms-length" transaction, thus contributing to problems in the subsidiary bank. Such a transaction could be in violation of Section 23A of the Federal Reserve Act. As you are aware, this section of the Act regulates extensions of credit between a member bank and its affiliates, including holding company subsidiaries, for the purpose of preventing adverse impacts on a bank through less than arms-length dealings with its affiliates.

In 1974 the Board published an interpretation of Section 23A reaffirming a 1958 interpretation, concluding that extensions of credit for purposes of Section 23A include purchases of obligations from an affiliate whether or not such purchases are made at a discount from face value. Thus, such extensions of credit would have to meet the amount and security limitations and requirements of Section 23A.

This interpretation is enclosed, and the Board wishes to emphasize that it continues to reflect the Board's view as to the applicability of Section 23A to this type of transaction. As the attached interpretation notes, however, the restrictions of Section 23A do not apply in those instances in which the transaction between the subsidiary bank and its affiliate is structured in an arms-length manner. For example, when the commitment to purchase is made in advance of the extension of credit by the affiliate, and is based upon the bank's independent evaluation of the credit-worthiness of the borrower, Section 23A would not be applicable, inasmuch as "the member bank would be taking advantage of an investment opportunity rather than being impelled by an improper incentive to alleviate working capital needs of the affiliate that are directly attributable to excessive outstanding commitments." Furthermore, these restrictions do not in any way interfere with the strength that a holding company can provide to its affiliates through management expertise and capital injections rather than credit extensions.

Since the example described in the first paragraph of this letter involves a possible violation of Federal law, the Board wishes to call the attention of each bank holding company to the provision in question as well as to make it clear that the Board might consider cease-and-desist proceedings under the Financial Institutions Supervisory Act of 1966 to be appropriate in such circumstances. Further, the Board wishes to note that under certain circumstances, such as where assets are purchased for significantly more than they would bring in an arms-length commercial transaction, the transactions could constitute a misapplication of bank funds and subject the officers and directors involved to possible criminal liability (18 U.S.C. § 656).

Situations may arise where the transaction itself does not technically violate Section 23A, for example, a transaction with a real estate investment trust that is advised by an affiliate of a member bank. However, if such a transaction were to involve the purchase of poor quality assets at significantly more than they would bring in an arms-length commercial transaction, it could constitute an unsafe and unsound practice and might subject the institution to cease-and-desist proceedings under the Financial Institutions Supervisory Act of 1966. Further, under certain circumstances such purchases could, as noted above, constitute a misuse of bank assets that would subject any officers or directors involved to possible criminal liability.

The Board expects that all bank holding companies and their subsidiary banks will adhere to both the letter

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and the spirit of Section 23A. The staffs of the Reserve Banks remain available for consultation with respect to any proposed transaction about which you have questions. Further, the Board's staff, as well as the Reserve Banks' staffs, will be closely scrutinizing transactions between subsidiary banks, their affiliates, and other "related" institutions in accordance with the principles cited.

The interpretation referred to above is contained in our Circular No. 7438, dated August 12, 1974; a copy of that circular is enclosed.

Any proposed transaction between affiliates about which you have questions may be discussed with Ben Stackhouse, Manager of our Domestic Banking Applications Department (Telephone No. 212-791-5859).

PAUL A. VOLCKER,
President.