FEDERAL RESERVE BANK OF NEW YORK

Circular No. 8861
June 25, 1980

Improper Diversion of Bank Income to Bank Holding Companies and Nonbank Affiliates

To All Banks and Bank Holding Companies in the Second Federal Reserve District:

This circular is being issued to summarize the policy of the Board of Governors of the Federal Reserve System regarding the improper diversion of bank income to parent holding companies or to nonbank affiliates. (A similar policy, regarding intercorporate tax practices, was set forth in our Circular No. 8429, dated October 3, 1978.)

These ''diversion-of-income'' practices include, but are not limited to:

—Management or service fees, or other payments assessed by the parent company or any affiliated entity and paid by the bank, that bear no reasonable relationship to the fair market value, cost, volume, or quality of services rendered by the affiliate to the subsidiary bank;

—Balances maintained by the subsidiary bank primarily in support of parent borrowings without appropriate compensation to the bank;

—Prepayment of fees to the parent or other nonbank affiliates for services that have not yet been rendered; and

—Non-reimbursed expenses incurred by the bank that primarily support a nonbank activity.

With regard to management or service fees, while the Board of Governors does not wish to prescribe the accounting methods to be used by bank holding companies, it does require that the methods employed give bank subsidiaries equitable treatment. Such equitable treatment would not result if the management or service fees do not bear a reasonable relationship to the fair market value of the services performed for or provided to the subsidiary bank. In practice, fair market value may be estimated by analyzing how the marketplace prices similar services in arms-length transactions in other business contexts and by adjusting, if necessary, for any circumstances that are unique to the bank or holding company. If fair market value cannot readily be determined or estimated, the cost to the parent of providing the service plus a reasonable profit margin would be considered an appropriate alternative measure of reasonableness. While determination of the market value or cost of services rendered may, in actuality, be a complicated and difficult process, the evaluation must be made in order to ascertain the reasonableness and appropriateness of the fees assessed by the parent company and paid by the bank.

In addition to service fees, the maintenance of bank balances as compensation for holding company borrowings has also, in some cases, provided an avenue for the improper diversion of bank income. In general, this practice is improper unless the bank is being compensated at an appropriate rate of interest.

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The prepayment of service fees to the parent company and payment by a bank of expenses primarily incurred in conjunction with nonbank holding company activities also are cause for supervisory concern. Prepayment of sums for services that are not to be provided in the immediate future can have an adverse impact on the bank, as can the bank's incurring large expenses on behalf of a holding company affiliate. If substantial bank expenses are incurred in support of a holding company activity, then the bank should be reimbursed for the portion of its cash outlay that benefits the holding company. This is necessary to insure that bank resources are not diverted to a holding company affiliate with little or no benefit to the bank.

As a matter of policy, each of the activities discussed above is considered inappropriate and, potentially, an unsafe and unsound banking practice. Aside from reasonable and timely fees for services rendered, the most appropriate way for funds to be paid to the parent company is through bank dividends. This applies, in general, to payment of funds by the bank in order to service holding company debt, even when the debt was initially incurred to raise equity capital for the subsidiary bank. It is not considered an appropriate banking practice for the subsidiary bank to pay management fees for the purpose of servicing holding company debt. Funds for servicing holding company debt should be upstreamed in the form of dividends.

Questions regarding this policy may be directed to our Holding Company Inspections Division (Tel. No. 212-791-5240).

ANTHONY M. SOLOMON,
President.

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