FEDERAL RESERVE BANK
OF NEW YORK

[ Circular No. 9799
February 6, 1985 ]

# BANK HOLDING COMPANIES

## Proposal on Real Estate Investment Activities

*To All Bank Holding Companies, and Others Concerned,*
*in the Second Federal Reserve District:*

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has requested comment on whether to initiate rulemaking that would establish the framework for bank holding companies to engage in real estate investment activities.

The Board's request for comment represents an effort to contain expansion of this activity within acceptable levels and subject to certain conditions designed to ensure that the activity does not result in unsound banking practices, conflicts of interest, unfair competition or other adverse effects.

Comment should be received by the Board on this matter by March 29.

The specific conditions on which the Board requested comment include:

— a requirement that the activity be conducted only through a direct real estate subsidiary of the bank holding company;

— a requirement that the bank holding company meet certain capital requirements before it could engage in real estate activities;

— a limitation of the bank holding company's investment to a passive, nonvoting equity investment;

— a limitation on the amount of the holding company's investment in real estate subsidiaries and a leverage limitation for the real estate subsidiary; and

— certain limitations on lending by the holding company and its affiliates to the real estate subsidiary, projects in which the subsidiary has an interest, co-venturers with the subsidiary and persons purchasing property in which the subsidiary has an interest.

The Board also asked for comment on whether the real estate investment activities should be limited geographically and whether the real estate subsidiary should be maintained as an independent organization separate in name and operation from any bank affiliate.

Finally, the Board seeks comment on whether additional or alternative rulemaking should be initiated to limit the conduct of real estate activities through nonbank subsidiaries of banks that are owned by bank holding companies and to establish special capital requirements for bank holding companies that control banks engaged in real estate activities.

Printed on the following pages is the text of the Board's proposal, which has been reprinted from the *Federal Register* of January 31. Comments thereon should be submitted by March 29, 1985, and may be sent to our Domestic Banking Applications Department.

E. GERALD CORRIGAN,
*President.*

Federal Register
Vol. 50, No. 21
Thursday, January 31, 1985

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## FEDERAL RESERVE SYSTEM

### 12 CFR Part 225

[Docket No. R-0537]

### Bank Holding Companies and Change in Bank Control; Regulation Y; Permissibility of Real Estate Investment for Bank Holding Companies and Their Direct and Indirect Nonbank Subsidiaries

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Solicitation of public comments.

**SUMMARY:** The Federal Reserve Board is soliciting comment on whether to commence a rulemaking proceeding under the Bank Holding Company Act to permit bank holding companies to participate in real estate investment activities and, if so, the conditions that should be established in order to ensure that the conduct of the activity does not result in unsound banking practices, unfair competition, conflicts of interests, or other adverse effects. The Board is seeking comment on a number of specific conditions, including a requirement that the activity be conducted only through a direct nonbank subsidiary of the bank holding company (the "real estate subsidiary"); a requirement that the real estate subsidiary be maintained independent in name and operation from any bank affiliate; compliance with certain capital requirements by a bank holding company desiring to engage in real estate activities; maintenance of adequate capital by the real estate subsidiary; a requirement that the real estate subsidiary's investment be limited to a passive, nonvoting equity investment; limitation on the amount of the holding company's investment in the real estate subsidiary and on the real estate subsidiary's leverage; limitations on the geographic scope of the activity; and limitations on lending by the holding company and its affiliates to the real estate subsidiary, any project in which the real estate subsidiary has an interest, a co-venturer or other co-participant with the real estate subsidiary in a real estate project, or purchasers of property in which the real estate subsidiary has an interest.

The Board is also seeking comment on whether, as an alternative or in addition to authorizing the activity for bank holding companies subject to certain prudential limitations, the Board should initiate rulemaking to prohibit the conduct of real estate activities through nonbank subsidiaries of banks that are owned by bank holding companies and to establish special capital requirements for bank holding companies that control banks directly engaged in real estate activities to reflect the increased risk to the bank holding company system from such activities.

**DATE:** Comments must be received by March 29, 1985.

**ADDRESS:** All comments, which should refer to Docket No. R-0537, should be mailed to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, Washington, D.C. 20551, or delivered to Room B-2223, 20th & Constitution Avenue, NW., Washington, D.C., between 8:45 a.m. and 5:15 p.m. weekdays. Comments may be inspected in Room B-1122 between 8:45 a.m. and 5:15 p.m. weekdays.

**FOR FURTHER INFORMATION CONTACT:** J. Virgil Mattingly, Associate General Counsel (202/452-3430), Scott G. Alvarez, Attorney (202/452-3583), Legal Division; William Taylor, Deputy Director (202/452-2773), Division of Banking Supervision and Regulation; or Edward Ettin, Deputy Director (202/452-3368), Division of Research and Statistics.

**SUPPLEMENTARY INFORMATION:**

#### I. Introduction

The participation by banking organizations in the business of real estate investment and development has long been limited by regulatory and supervisory restrictions enacted over the years to deal with the risks, conflicts of interests, and other potential adverse effects presented by direct and indirect involvement in the activity. For example, national banks are prohibited by Federal statute from investing in real estate, other than for bank premises, and State member banks are not authorized under the Board's Regulation H (12 CFR Part 208) to engage in real estate investment activities. Moreover, most current State laws either prohibit or do not permit State banks to hold, invest in, or develop real estate (except for bank premises and certain other limited circumstances). Similarly, the Board in 1972 determined that real estate investment and development activities were not closely related to banking and thus were not permissible activities for bank holding companies. Federal thrift institutions are permitted to conduct real estate investment activities, but only on a limited basis and subject to restrictions imposed by the Federal Home Loan Bank Board ("FHLBB").

The basis of this concern with the real estate activities of banks may be traced to a number of factors, including conflicts of interests and the financial risks involved in this activity. The ability of banks to make objective credit judgments and to serve as impartial providers of credit would appear to be subject to various conflicts of interests when a depository institution acts in the role of both lender and real estate investor or developer. With respect to the financial risks, real estate investments typically are not liquid and the economic returns can be very uncertain.

Recently, several states have enacted legislation authorizing banks chartered in those states to engage in broad real estate investment and development activities. In addition, some states permit real estate investment on a limited basis, while others permit this activity only for state savings banks. The real estate activities authorized include the direct acquisition and development of real estate, participation in partnerships or joint ventures with construction companies or developers, or acquisition of an interest in already developed real estate.

Similar statutes are likely to proliferate driven in many cases by competitive pressures from states that have authorized real estate activities or from other providers of financial services.

#### II. Proposals by FDIC and FHLBB to Limit Real Estate Activities

In recognition of the risks in real estate development activities and the increasing activity at the state level authorizing state-chartered banks to engage in real estate investment and

development, the FDIC on December 13, 1984, published for comment a proposal to prohibit insured banks from engaging directly in real estate development and underwriting activities (and certain other activities, including insurance underwriting) where authorized by state law and to require that such activities be conducted only through a "bona fide subsidiary" of the bank. 49 FR 48552 (December 13, 1984). The proposal is based upon the permise that the conduct of these types of activities by insured banks is unsafe and unsound, but that risks to the bank may be avoided if the activities are conducted in a separate but affiliated corporation whose obligations are not the legal obligations of the bank.[1] Similarly, the Federal Home Loan Bank Board on December 10, 1984, proposed a rule requiring prior supervisory review for direct investment in real estate, service corporations, and equity securities above certain threshold amounts by thrift institutions whose accounts are insured by the Federal Savings & Loan Insurance Corporation. 49 FR 48743 (December 14, 1984). The FHLBB's proposal was prompted by the significantly expanded powers granted by state legislation to state-chartered thrift institutions and concern that the exercise of these powers could expose the institutions and FSLIC to an excessive degree of risk. Both the FDIC and the FHLBB proposals have the effect of limiting the ability of state-chartered institutions to engage in real estate development activities authorized by state statute.

## III. Possible Prudential Limitations on Real Estate Investment

The Board shares the concern of the FDIC and the FHLBB with respect to the potential risks of these expanded activities to banking and thrift institutions. Accordingly, the Board has decided to seek public comment on whether it should act to set a framework for the conduct of these real estate activities by bank holding companies and their direct and indirect nonbank subsidiaries under rules that will help assure that these activities are carried out in a manner so as to avoid unsound banking practices, unfair competition, conflicts of interests, any adverse effect on the financial resources of the holding company or its subsidiaries, and other adverse effects. The Board also seeks comment on whether the activity of real estate investment as described in more detail below can be authorized by the Board pursuant to its authority under section 4(c)(8) of the Bank Holding Company Act to permit activities that are closely related to banking and a proper incident thereto. 12 U.S.C. 1843(c)(8).

More specifically, the Board is seeking comment on the following requirements and conditions for the conduct of the activity:

1. *Separate Subsidiary.* Whether the conduct of the activity should be limited to a separately incorporated direct nonbank subsidiary of the bank holding company (the "real estate subsidiary") and, as discussed in Part IV below, prohibited for subsidiaries of holding company banks through an amendment to § 225.22(d)(2) of Regulation Y (12 CFR 225.22(d)(2)).

In this regard, the Board requests comment on whether it should also impose conditions similar to those proposed by the FDIC in its nonbanking activities proposal, to ensure that the real estate subsidiary is maintained as an independent organization separate from any of its bank affiliates. Such conditions might include a requirement that the real estate company not use corporate names or logos in common with bank affiliates; maintain separate offices from any affiliated bank; have no officers or employees in common with any affiliated bank; establish a board of directors, a majority of whom are neither officers nor directors of any affiliated bank; and conduct business pursuant to independent policies designed to inform customers that the real estate subsidiary is separate from its banks affiliates, and that investments recommended, offered, or sold by the real estate subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by any bank affiliate or otherwise an undertaking or obligation of any bank affiliate.

2. *Adequate Capitalization by the Parent.* Whether the activity should be limited to only bank holding companies whose primary and total capital, on a consolidated basis, and that of each of its subsidiary banks, equals or exceeds the minimum levels specified in the Board's Capital Adequacy Guidelines (Appendix A to 12 CFR Part 225). In determining compliance with the Guidelines, the amount of investment in and advances to the real estate subsidiary by the bank holding company and its nonbank subsidiaries would not be included. In the event the bank holding company's consolidated primary or total capital falls below these levels, a bank holding company could not make any further investment in the real estate subsidiary and the real estate subsidiary could not commence any additional real estate investment activities or projects without the Board's prior approval.

3. *Limitation on Investment in Real Estate Subsidiary.* Whether the aggregate investment in and extensions of credit to all of a holding company's real estate subsidiaries by the bank holding company and its nonbank subsidiaries should be limited to a stated percentage of the holding company's primary capital (*e.g.*, 5–10 percent). In addition, the Board seeks comment on whether this limitation on investment should include not only extensions of credit to the real estate subsidiary by the bank holding company and its nonbank subsidiaries but also extensions of credit to the real estate subsidiary by subsidiary banks of the holding company.

The investment limitation described above might be unduly restrictive for smaller banking organizations. Accordingly, the Board seeks comment on alternative methods of establishing investment limits for these institutions consistent with safe and sound banking practices.

4. *Leverage Limitation.* Whether the total amount of borrowing by a real estate subsidiary from all sources should be limited to a stated percentage of the real estate subsidiary's capital (*e.g.*, five times its capital).

5. *Geographic Limits.* Whether the activities of the real estate subsidiary should be authorized on a nationwide basis. Alternatively, the Board seeks comment on whether the activity should be limited to only bank holding companies whose home state [2] authorizes real estate activities for state banks chartered in that state. For example, under this approach, a bank holding company in Ohio, which has authorized real estate activities for Ohio banks, would be able to conduct real estate activities anywhere in the country, while a bank holding company located in a state that has not authorized the activity would not be allowed to conduct the activity at all.

[1] The FDIC proposal is designed to isolate the real estate subsidiary from its parent bank by imposing a number of restrictions on the operation of real estate subsidiaries and affiliates of insured banks (*e.g.* adequate capitalization, physical separation, no use of parent's name or logo, separate records, independent board of directors, no common officers, and policies designed to inform customers their investments are not insured by the FDIC. The proposal also establishes certain lending limitations, including limitations on loans by an insured bank to its real estate subsidiary and to persons purchasing property in which the real estate subsidiary has an interest.

[2] For this purpose, the "home state" of a bank holding company is the state in which the bank holding company's banking subsidiaries principally conducted their banking operations on July 1, 1966, or the date the company became a bank holding company, whichever date is later.

As an additional alternative, the Board seeks comment on whether real estate activities of bank holding companies should be limited to only those states that specifically authorize such activities for banks or bank holding companies operating in those states (or alternatively that do not prohibit banks and bank holding companies operating in that state from conducting these activities). For example, a New York bank holding company could engage in real estate activities in New York, which has authorized the activity for New York banks nationwide, but under this alternative could not perform the activity outside of New York unless the state in which the activity is to be performed authorizes the activity, or alternatively, does not act to prohibit the activity.

6. *State Limitations.* Whether the real estate subsidiary should conform to any limitations applicable to state banks conducting the activity in bank holding company's home state. For example, states may establish community investment requirements or prohibit certain types of real estate activities (*e.g.,* the acquisition of an equity interest in a one-to-four family home which is the principal residence of the owner).

7. *Limitation to Essentially Passive Investments.* Whether the real estate subsidiary's investment in any real estate should be limited to an essentially passive, joint venture investment, thereby giving effect to the interest of the banking organization in achieving a share of any appreciation in the value of the investment, while continuing to maintain a separation of the banking enterprise from participation in the commercial activities involved in design, engineering, construction, marketing and similar activities with respect to real estate projects. Accordingly, the Board seeks comment on whether voting equity investments by the real estate subsidiary in real estate projects should be subject to limits (*e.g.,* no more than 25 percent of total voting equity of the real estate project) and whether any additional investment should take the form of nonvoting equity investments or limited partnership interests. The Board also seeks comment on whether the real estate subsidiary's total voting and nonvoting investment in a real estate project should be limited to a stated percentage (*e.g.,* 75 percent) of the project's total equity, thus requiring that joint venturers with the real estate subsidiary have a financial stake in any real estate project.

8. *Appropriate Scope of Real Estate Activities.* Whether the scope of real estate activities authorized for a real estate subsidiary should include activities beyond the acquisition of an ownership interest in improved or unimproved real estate to be held for investment or development purposes. In particular, the Board requests comment on whether the real estate subsidiary should be prohibited from engaging directly in construction, research, architectural, engineering, development, marketing or similar activities with respect to real estate and from engaging in property management, real estate brokerage, real estate syndication services, and title insurance. The Board seeks comment on whether the real estate subsidiary should, however, be permitted to enter into agreements for construction, development, maintenance, or similar activities with respect to property in which it has an ownership interest. In this regard, the Board seeks comment on whether such activities are closely related to banking and a proper incident thereto.

9. *Lending Limitations.* Under section 23A of the Federal Reserve Act, any extension of credit by an insured bank to an affiliated holding company real estate subsidiary and any entity the subsidiary controls would be subject to an aggregate lending limit of 10 percent of the bank's capital and surplus and all such extensions of credit must be adequately collateralized within the meaning of that statute. 12 U.S.C. 371c.

The Board seeks comment on whether additional, separate lending limitations (*e.g.,* based upon a percentage of the holding company's primary capital) should be applied to loans by the bank holding company and any of its subsidiaries, including its subsidiary banks, to (1) any person for the purpose of acquiring an interest in any real estate in which the real estate subsidiary has a direct or indirect interest; (2) any real estate project in which the real estate subsidiary has an interest; or (3) any entity with which the real estate subsidiary is associated by joint venture or similar arrangement in connection with the conduct of real estate activities. The Board also requests comment on whether an aggregate limit on all such extensions of credit (*e.g.,* based upon a percentage of the consolidated primary capital of the bank holding company) should be established. The Board requests comment on whether these lending limitations should include a requirement that the extension of credit be consistent with safe and sound banking practices, made on market terms, including interest rates and collateral, and not involve more than the normal risk of repayment or present other unfavorable features.

In addition, in order to reduce a bank holding company's exposure to loss on any individual project, the Board requests comment on whether a limitation should be established on the holding company system's aggregate exposure, including both equity investment and loans, in connection with any individual project.

10. *Limitation on Purchases as Fiduciary.* Whether the Board should limit a bank holding company and any of its subsidiaries from purchasing or leasing as fiduciary, co-fiduciary, or managing agent on behalf of an account for which the holding company or subsidiary has investment discretion, any property in which a real estate subsidiary of the holding company has an interest or which it sells or markets unless the purchase or lease is consistent with the standards of care and conduct applicable to fiduciaries.

## IV. Limitation on Real Estate Activities Within a Bank Holding Company System

As an alternative to establishing a framework that would authorize bank holding companies to engage in real estate investment activities subject to certain prudential limitations, the Board seeks comment on whether, in light of the financial risks and potential conflicts of interests as well as other adverse factors outlined earlier in this notice, it is more appropriate for the Board *not* to authorize bank holding companies to conduct real estate activities. In this event, the nonbanking prohibitions of section 4 of the Act would continue to prohibit bank holding companies and their nonbank subsidiaries from conducting real estate investment and development activities. It may also be necessary, in order to prohibit real estate development activities, for the Board to engage in rulemaking to amend the provisions of § 225.22(d)(2) of Regulation Y (12 CFR 225.22(d)(2)) to eliminate the regulatory exemption from the nonbanking prohibitions of the Act currently enjoyed by subsidiaries of holding company banks under that section of Regulation Y. This step would apply the Act's limitations on nonbanking activities to the real estate subsidiaries of holding company banks.[3]

[3] The Bank Holding Company Act prohibits, with certain exceptions, a bank holding company from acquiring or retaining direct or indirect ownership or control of more than 5 percent of the voting shares of any company (which term includes a partnership, business trust or similar association)

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Section 225.22(d)(2) (formerly § 225.4(e)) of Regulation Y was adopted in 1971 and allows holding company state-chartered banks to acquire or retain *all* of the voting shares of a nonbank company so long as the nonbank company engates solely in activities in which the parent bank may engage directly, at locations at which the bank may engage in the activities. 12 CFR 225.22(d)(2). The Regulation thus permits a holding company state bank to establish a wholly-owned subsidiary to engage in nonbanking activities that the state bank may conduct directly even though the activities are not otherwise permitted for bank holding companies. This regulation reflects the Board's decision in 1968—consistent with a 1966 ruling by the Comptroller for national banks—to permit state member banks to form wholly-owned operations subsidiaries to engage in activities authorized for the bank itself.[4]

In this connection, the Board's evaluation of an appropriate course of action with regard to this provision could be affected by the FDIC's action on its pending proposal to limit real estate development activities of insured banks.

If the FDIC adopts its proposed rule on real estate development activities of insured banks, the combined effect of this rule and the present provisions of § 225.22(d)(2) of Regulation Y would prohibit real estate development by an insured bank directly and in a subsidiary of a holding company bank because such activities would not be permissible in the bank. Thus, holding companies and their subsidiaries, including their bank subsidiaries, would be prohibited from engaging in real estate development activities, and only nonmember banks that are not in holding company systems would be permitted to engage in these activities through subsidiaries of those banks.

In this situation where the FDIC adopts its proposal, the Board requests comment on whether it should maintain the existing provisions of Regulation Y which would have the effect of prohibiting real estate development activities through the subsidiaries of all holding company banks, whether member or nonmembers. The Board also requests comment on the impact of the lack of coverage under these rules of nonmember banks that are not in holding company systems.

In the situation in which the FDIC does not adopte its proposed rule, or in any event, the Board, as noted above, is considering whether to amend § 225.22(d)(2) of Regulation Y to apply the nonbanking activity restrictions of the Act to nonbank subsidiaries of holding company banks. The possibility that such an amendment might be necessary was recognized by the Board at the time § 225.22(d)(2) was adopted in 1971. At that time the Board stated that it would not apply the nonbanking prohibitions of the BHC Act to nonbank subsidiaries of holding company banks unless changed circumstances indicated a need to apply the provisions in order to carry out the Act's purpose or to prevent evasions of the Act. Accordingly, the Board stated that it would review the merits of that decision from time to time:

> The Board should not at this time apply the [nonbanking] restrictions [of the BHC Act] to subsidiaries of banks. This decision is believed warranted by considerations of equity between banks that are and are not members of bank holding companies and by the absence of evidence that acquisitions by holding company banks are resulting in evasions of the purposes of the Act. The merits of this decision will be reviewed by the Board from time to time in light of its experience in administering the Act. (Board Press Release dated January 25, 1971.)

The developments discussed above regarding broad state authorizations for real estate development activities suggest that reconsideration of the Board's 1971 regulations allowing holding company state banks to retain subsidiaries engaged in activities the parent bank holding company may not conduct directly is now appropriate. Accordingly, the Board requests comment on whether it should amend § 225.22(d)(2) to apply a prohibition on real estate activities to the subsidiaries of banks in holding company systems.

In particular, comment is requested on whether this rule should be adopted in the situation in which the FDIC does not act to adopt its proposed rule on this matter. In such a situation, it would be permissible for state-chartered banks to engage in real estate development activities directly if authorized under state law. In order to deal with the potential risks to the safety and soundness of the banking and financial system that could arise in this situation, the Board requests comment on whether it should also exercise its authority under the Bank Holding Company Act and the International Lending Supervision Act to impose special capital requirements on bank holding companies that own a bank that engages in real estate investment activities. 12 U.S.C. 1844(b), 3907, and 3909. The types of requirements under consideration are the same as those outlined in Part III(2) above.

**List of Subjects in 12 CFR Part 225**

Banks, Banking, Holding companies, Securities.

Board of Governors of the Federal Reserve System, January 28, 1985.

**William W. Wiles,**

*Secretary of the Board.*

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other than a bank. By encompassing indirect as well as direct ownership interests, this provision of the Act prohibits a holding company subsidiary *bank* as well as the holding company itself from owning more than 5 percent of the voting shares of any company engaged in impermissible nonbank activities such as real estate investment and development. The Board has since enactment of the Act held this view. 12 CFR 225.102. This conclusion is further supported by section 2(g)(1) of the Act, which provides that any voting shares held by any holding company subsidiary (bank or nonbank) are presumed held by the holding company itself. 12 U.S.C. 1841(g)(1).

[4] 12 CFR 250.141. The premise for the adoption by the Board of § 225.22(d) was that a subsidiary of a bank was equivalent to a department or division of the bank. If, on the other hand, a nonbank subsidiary of the bank is to be separate and wholly independent of the bank, as required under the FDIC proposal, such a "bona fide subsidiary" would clearly not be the type of subsidiary that was intended to be authorized under § 225.22(d)(2) of Regulation Y.