Bank Affiliate Transactions: Navigating Sections 23A and 23B of the Federal Reserve Act

Complying With Regulation W's Complex Restrictions on Business Dealings With Affiliate Institutions

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Regulation of Bank-Affiliate Transactions

Sections 23A and 23B of the Federal Reserve Act
And the Federal Reserve’s Regulation W

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Why Regulate Affiliate Transactions?

• Protect federally insured depository institutions from misuse of their resources in transactions with their affiliates

• Curtail the ability of commercial banking organizations to transfer to nonbank within the holding company system the subsidy arising from banks’ access to the Federal safety net
  - Insured deposits
  - Payment system
  - Discount window
Statutory Methodology

• Section 23A of the Federal Reserve Act (“FRA”), 12 U.S.C. § 371c
  - Imposes quantitative (and some qualitative) restrictions on transactions with affiliates
  - Enacted as part of the Banking Act of 1933, along with
    • the creation of federal deposit insurance and the FDIC
    • the Glass-Steagall Act separating commercial from investment banking

• FRA § 23B, 12 U.S.C. § 371c-1
  - Imposes qualitative restrictions on affiliate transactions (market terms)
  - Enacted as part of the Competitive Equality Banking Act of 1987
Interpretive & Exemptive Authority

- Initially (i.e., after enactment of FRA §§ 23A (1933) and 23B (1987), the Board of Governors of the Federal System (the “Board”) exercised interpretive & exemptive authority
  - Pre-Internet: only for the cognoscenti (FRRS and “secret law”)
  - Board still provided interpretation by letter and commitments
- The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) were granted exemptive authority (comparable to the Board’s) by Dodd-Frank § 608 (effective July 21, 2012)
Key Concepts

- **Member Bank**

- **Affiliate** – broadest definition in banking law

- **Covered Transactions**
  - Credit and credit support
  - Asset purchases

- **Collateral Requirements** – varies with nature of collateral

- **Attribution**

- **Default Limitations**
  - Low quality assets
  - Safety and soundness

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Suggested Analytical Approach

Whenever a bank contemplates a transaction with another entity (not a transaction with a natural person), the bank needs to ask:

1. Is the entity an “affiliate”?
2. Is the matter in question a “covered transaction” under § 23A or a “listed transaction” under § 23B?
3. If so, is the transaction exempt (or do we have an argument for seeking an exemption)?
4. If not, is it (A) in compliance with the applicable quantitative restrictions and collateral requirements and (B) on substantially similar terms as those available to third parties?
Section 23A Definition of “Affiliate”

Controlling, controlled by, or under common control
Not a common law but a statutory concept

• Affiliation is a statutorily defined index of relatedness that subjects one or both related entities to a particular legal treatment.

• There is, however, no single, “one size fits all” definition of that index of relatedness that applies to all statutory schemes. Typically, each different regulatory regime is predicated upon an explicit statutory definition of what the legislature means by “affiliate.”

Examples of 23A Affiliates

- Parent BHC
- Companies controlled by BHC or under common control
  - N.B. IDIs are treated as affiliates for some purposes
- Companies with interlocking directorates
- Financial Subsidiaries
- Portfolio Companies (merchant banking authority)
  - ≥15% equity capital, but subject to exceptions
- Partnerships
- Subsidiaries of affiliates
- Sponsored/advised entities (including investment company for which bank or affiliate acts as investment adviser)
- Other companies as prescribed by the Fed
Controlled by/under common control

- ≥ 25% voting securities (including convertible securities)
- General partner of partnership
- Manager of LLC
- Ability to select a majority of directors
- Ability to exercise “controlling influence over management or policies” (after notice and opportunity for a hearing)
- Lower thresholds through management interlocks, agreements, restrictions on transfer, voting agreements, and other methods of acting in concert
Entities **Not Considered Affiliates**

- Subsidiaries of the bank, except for --
  - Financial subsidiaries
  - Companies controlled directly by an affiliate or a s/h or group of s/hs that control the bank
  - Depository institutions (except for 23B purposes)
  - ESOPs, trusts, or similar arrangements that benefit s/hs, partners, members or employees of the bank or its affiliates
- “Sister Bank” Exemption
- Safe Deposit Companies
- Companies engaged solely in holding obligations of, or guaranteed as to principal and interest by, the U.S. Government or its agencies
- Bank premises companies
- DPC subsidiaries

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“Covered Transactions”

Transactions in which a bank provides actual or potential monetary benefit or support to an affiliate
“Covered transactions” (1)

- Loan or extension of credit
  - After Dodd-Frank, includes repurchase transactions
- Providing a guaranty, acceptance, letter of credit (or confirming a L/C issued by an affiliate), or a “cross-affiliate netting arrangement”
- Purchasing assets from an affiliate (exemptions available)
- Purchasing or investing in securities issued by an affiliate
- Accepting securities issued by an affiliate as collateral
  - After Dodd-Frank, accepting any debt obligation of an affiliate as collateral for a loan was added to the list
“Covered transactions” (2)

• Effective July 21, 2012, and to the extent the transaction causes the bank to have credit exposure to the affiliate –
  - Securities lending
  - Securities borrowing
  - Derivatives transactions

• Further gloss on what constitutes an extension of credit –
  - Failure of an affiliate to make timely payment for services
  - Overnight (as opposed to daylight) overdrafts

• Dodd-Frank § 608(a) --
  - authorizes the Board to issue interpretations and/or regulations addressing the manner in which a netting agreement may be taken into account for purposes of determining the amount of a covered transaction
Attribution Rule

• A transaction with any person will be deemed for purposes of §§ 23A/23B, to be a transaction with an affiliate if the proceeds are either transferred to the affiliate or used for the benefit of the affiliate

• Example of application: when a bank and its affiliate both make loans to the same borrower

• Exceptions:
  - Certain riskless principal transactions
  - Purchase by customer from affiliate with general purpose bank credit card
  - Brokerage fees, commissions, & riskless principal mark-ups (must meet the 23B standard)
Section 23A Rule re: Covered Transactions

Quantitative Requirements; Collateral Requirements; Qualitative Requirements
Quantitative Limitations

- All covered transactions between the bank and any one affiliate may not exceed 10% of the bank’s capital and surplus
  - Prior to Dodd-Frank financial subsidiaries were not subject to this requirement, but they are now.
- All covered transactions with all affiliates in the aggregate may not exceed 20% of the bank’s capital and surplus
- N.B. An open-ended guaranty violates these restrictions
Collateral Requirements

• All loans or extensions of credit to affiliates must be collateralized between 100 – 130% of the principal amount, depending on the riskiness of the collateral –
  - Cash and U.S. Treasury Securities 100%
  - Obligations of States and Political Subdivisions 110%
  - All other debt obligations 120%
  - Stocks, leases, realty or personalty 130%

• Bank must maintain a perfected security interest (S/I), enforceable under applicable law (including in the event of bankruptcy), in permissible collateral
  - N.B. S/I must be first priority. If not, must deduct from the collateral value the lesser of (i) the amount of any more senior S/I or (ii) the amount of any credit secured by that senior S/I
PROBLEM: Bank wishes to issue a $500,000 line of credit to an affiliate. The affiliate posts $120,000 in U.S. Treasury securities, $120,000 worth of corporate bonds, and a parcel of real estate appraised at 350,000. Does this loan meet 23A’s collateral requirements?
**Answer to Collateral Problem**

<table>
<thead>
<tr>
<th>Collateral Type</th>
<th>Percentage</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasuries</td>
<td>100%</td>
<td>$120,000</td>
</tr>
<tr>
<td>Bonds</td>
<td>120%</td>
<td>$100,000</td>
</tr>
<tr>
<td>Real Estate</td>
<td>130%</td>
<td>$269,230</td>
</tr>
</tbody>
</table>

Supports loan amount of: $489,230

**Conclusion:** In order to make this loan, the bank needs additional collateral of $10,770 in Treasuries or $12,924 in bonds or else a substitute parcel of real estate worth (in round numbers) at least $370,000.
Changes in Collateral Valuation

• Historically:
  - Collateral values were calculated as of the time of the loan. In the case of a line of credit, collateral had to cover the entire line, including any unused portion, or else the bank had no obligation to advance further funds until the affiliate topped off the collateral already posted.
  - Retired or amortized collateral had to be replaced.
  - If the value of the collateral declined, there was no 23A violation so long as the transaction was lawful when initiated.

• Dodd-Frank § 608(a) amended § 23A to require that the requisite collateral amount be maintained “at all times.”

• Then, as now, a renewal or rollover is treated as a new loan or extension of credit.
Ineligible Collateral

- Securities issued by any affiliate
- Letters of Credit, guaranties, and similar instruments
- Intangible assets (including servicing assets) unless prior regulatory approval is obtained
- “Low quality” assets
- Equity securities of the bank
- Debt securities of the bank that constitute regulatory capital
Qualitative Requirements of § 23A

• *All* transactions – not just “covered transactions” but those exempt from the definition as well – must be consistent with safe and sound banking practices.

• Absolute prohibitions regarding “low quality assets”
  - May not serve as collateral as loan
  - May not be purchased by the bank

• Definition of “low quality assets”
  - Graded by examiners as OAEM, Substandard, Doubtful or Loss
  - Nonaccrual status or past due for more than 30 days
  - Renegotiated assets (deteriorating condition of obligor)
  - Acquired via foreclosure, repossession or otherwise on a DPC basis (unless reviewed by the examiners)
Special Rules for Thrift Institutions

• Under Regulations of the now defunct OTS:
  - Investments in affiliates (other than subsidiaries) were forbidden
  - Loans or extensions of credit to an affiliate engaged in any activity other than those permissible for a standard bank holding company (i.e., not a financial holding company) were forbidden
  - OTS historically did not attribute to a parent activities conducted by a subsidiary

• Subpart I to the Board’s Reg. W (adopted 2011) retains the substance of the former OTS regulations, with some terminology changes, except that it dispenses with any recordkeeping and notification requirements
Exceptions to § 23A (1)

- Payment of dividends by a bank
- Sale of assets to an affiliate (but still subject to § 23B)
- Purchase of loans on a nonrecourse basis from an affiliated IDI
- “Sister bank” exemption
  - 80% ownership requirement
  - Remains subject to prohibition on purchasing low quality assets
- Credit for uncollected items
- Correspondent banking deposits
- Liquid assets, marketable securities, and munis
- Purchase of an extension of credit subject to a repo
Exceptions to § 23A (2)

- Asset purchase by a newly formed bank
- Transactions approved in connection with a Bank Merger Act transaction
- Purchasing an extension of credit originated by an affiliate
- Intraday extensions of credit
- Riskless principal transactions
- Transactions approved in connection with certain corporate reorganizations
Section 23B Rules
Covered Transactions +

Qualitative Requirements
Basic Rule – Market Terms

• Applies to covered transactions and other transactions (collectively, “listed transactions” – see next slide) in which a bank pays money or provides services to an affiliate. A transaction between a bank and any person must, in general, be treated as a listed transaction with an affiliate if any proceeds are used for the benefit of, or transferred to, the affiliate.

• **Transaction must be on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with non-affiliated persons**

  - If there are no comparable transactions, must apply the same standard that would, in good faith, be offered or applied to non-affiliated persons.
Listed Transactions under § 23B

- Any covered transaction with an affiliate
- Sale of securities or other assets to an affiliate, including assets subject to a repurchase agreement
- Payment of money or furnishing of services to an affiliate under contract, lease, or otherwise
- Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person
- Any transaction or series of transactions with a third party if (i) an affiliate has a financial interest in the third party or (ii) the affiliate is a participant in each transaction or series of transactions
Other Key Provisions of § 23B

- Prohibition on purchasing, in a fiduciary capacity, any asset (including securities) from an affiliate unless permitted by applicable law, the governing trust instrument, or court order.

- Prohibition on purchasing (as principal or as fiduciary), during a securities underwriting or syndication, any security for which an affiliate is a principal underwriter, unless the purchase receives advance approval by a majority of the directors based on a determination that it is a sound investment regardless of that fact that an affiliate is a principal underwriter.

- Advertisements or agreements suggesting that the bank is responsible for an affiliate’s obligations is also prohibited.

  - N.B. A guaranty complying with § 23A is permitted, however.
Valuation & Timing under Reg. W
Credit & Credit Support

• Re: loans, extensions of credit, guaranties, L/Cs, and acceptances, the transaction must be valued *ab initio* at the largest of
  - the principal amount
  - the amount owed to the bank by the affiliate, or
  - the sum of the amount provided to, or on behalf of, the affiliate and any additional amount the bank could be required to provide

• A transaction acquired from a non-affiliate must be valued *ab initio* at the sum of the total consideration given and any additional consideration the bank could be required to provide to, or on behalf of, the affiliate
Purchase of Assets from Affiliate

- The purchase must be valued at the total consideration given for the asset but reduced to reflect amortization or depreciation to the extent consistent with generally accepted accounting principles ("GAAP")

- The purchase remains a “covered transaction” for as long as the bank holds the asset
Purchase/Investment in Affiliate’s Securities

- Must be valued at the greater of –
  - The total consideration given for the security but reduced to reflect amortization of the security to the extent consistent with GAAP; or
  - The carrying value of the security

- The purchase/investment remains a “covered transaction” for as long as the bank holds the security
Affiliate’s Securities as Collateral

• Where securities issued by an affiliate are the exclusive collateral for a loan, the transaction must be valued at the lesser of –
  - The total value of the loan; or
  - The fair market value of the securities pledged as collateral

• Where securities issued by an affiliate are but part of the collateral for a loan, the transaction must be valued at the lesser of –
  - The total value of the extension of credit less the fair market value of non-affiliate collateral; or
  - The fair market value of the securities issued by an affiliate that are pledged as collateral
What Hath Dodd-Frank Wrought?

The Volcker Rule and Other Cocktail Party Topics
The Volcker Rule’s “Super 23A”

- Dodd-Frank § 619 added new § 13 to the Bank Holding Company Act of 1956, as amended, 12 U.S.C. § 1851, to prevent banking organizations from “gambling” with depositors’ funds by engaging in risky trading activities or risky private equity fund or hedge fund investments.

- The “Final” Volcker Rule, promulgated December 10, 2013, prohibits any banking entity serving as (A) investment manager, investment adviser, commodity trading adviser, or sponsor to, (B) organizer of, or (C) holder of an ownership interest in, a covered fund, or any affiliate of such banking entity, from entering into any transaction with a covered fund and any controlled funds that would constitute a “covered transaction” under § 23A
Why is it dubbed “Super 23A”

• Section 23A does not, in general, prohibit covered transactions with affiliates but typically imposes quantitative and qualitative restrictions.

• The Volcker Rule prohibits such transactions entirely – hence, the “Super” 23A moniker.

• Note, however, that the Final Rule does not incorporate the § 23A attribution rule, which regards a third-party transaction as an affiliate transaction if the proceeds are transferred or any benefits accrue to an affiliate.

• Note also an exemption from Super 23A for “prime brokerage transactions” by a banking entity with a covered fund.
Dodd-Frank § 608 & Covered Transactions

- Expands definition (and the low quality asset prohibition) to include derivatives transactions and securities lending and borrowing transaction between a bank or its subsidiary and any affiliate to the extent the transaction causes the bank or subsidiary to have “credit exposure” (not defined in Dodd-Frank) to the affiliate.
  - Under Reg. W, derivatives transactions are subject to § 23B
  - Certain credit derivatives in which a bank provides credit protection to a third-party dealing with an affiliate are subject to § 23A, but banks are generally required to have policies and procedures to manage “credit exposure” from derivatives. Treating such “credit exposure” as a covered transaction is a sea change to § 23A and will likely increase transaction costs.
  - Prior Board letter rulings granted exemptions for securities lending/borrowing programs with some credit exposure but were not deemed to pose substantial risk. Requiring conformance with § 23A restrictions and collateral requirements will increase transaction costs.
More on D-F § 608

• Affiliate debt securities were already within the “covered transaction” realm. Now “other debt obligations” issued by an affiliate as collateral have been added.
• Financial subsidiaries lost a partial exemption from the 10% basket for transactions with any one affiliate
• Definition of “affiliate” now includes any investment fund with respect to which a bank or affiliate thereof is an investment adviser
• Repurchase agreements are now consider extensions of credit and subject to collateral requirements
• The Board may take into account netting arrangements for derivatives and securities lending transactions if these are fully secured by gubbies or segregated deposits
D-F § 608: Changes to Exemptive Authority

- The Board no longer has exclusive authority to grant § 23A exemptions and its authority to do so by order has been eliminated and now may be done only by regulation.

- Section 608 permits the FDIC and OCC to grant exemptions from § 23A by order with respect to banks and thrifts under their supervisory power if they determine, jointly with the Board, that doing so is in the public interest.

- FDIC has veto power over exemptions by the Board and OCC, both of which must give FDIC 60 days’ advance notice in which to exercise that veto, which it must do in writing based on a determination that the exemption would present an unacceptable risk to the deposit insurance fund.
A Note on Enforcement
Violations of 23A/23B or Reg. W

- Any such violation will likely be uncovered during the normal examination/supervisory process
- The bank regulators may exercise all of their enforcement powers against IDIs and institution-affiliated parties (directors, officers, etc.) under Section 8 of the Federal Deposit Insurance Act, 12 U.S.C. § 1818:
  - Cease-and-desist authority
  - Removal and prohibition authority
  - Civil money penalty authority
- Civil money penalties for these sorts of violations may well be third-tier and can be up to $1 million per violation for each day the violation has continued
Bank Affiliate Transactions: Navigating Sections 23A and 23B of the Federal Reserve Act

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Firewalls Imposed in Section 23A and 23B of the Federal Reserve Act (the “FRA”)

- Designed to limit a bank’s risks from transactions with its affiliates and the resulting potential exposure of risk to the Federal safety net.
- Regulates a bank’s loans to and investments in affiliates in two ways –
  1) Restricts the amount of the loans or investments (“covered transactions”) made by the bank in an affiliate; and
  2) Establishes collateral guidelines for covered transactions that are allowed.
Legislative History – Key Dates

- June 6, 1933 – Section 23A of the FRA enacted. 12 U.S.C. §371c
July 21, 2012 – Section 608 of the Dodd-Frank Act (the “DFA”) becomes effective.

The changes to the FRA made by DFA (summarized below) expanded coverage of Section 23A, and gave the Federal Deposit Insurance Corporation (the “FDIC”) a veto power over the Federal Reserve Board’s (the “FRB”) rulemaking power.
Summary of DFA’s Amendments to Section 23A

Modifies the definition of an affiliate to include an investment fund for which the bank or any of its affiliates is an investment advisor. Expands the definition of what is considered a covered transaction to include:

- Repurchase agreements (now considered an extension of credit);
- Transactions where debt obligations of an affiliate are pledged as collateral for a loan the bank makes to a third party;
- Derivative transactions with an affiliate to the extent it creates a “credit exposure” to the bank; and
- Transactions with an affiliate that involves borrowing or lending securities that creates a “credit exposure” to the bank.
Collateral Requirements – additional requirements in two cases:

- Repurchase agreements; and
- A bank’s credit risk exposure to derivatives and borrowing/lending transactions with affiliates

Changes in Qualitative Standards

- Extends the prohibition of the acceptance of low-quality assets of securities issued by an affiliate as collateral for an extension of credit.
Netting

- Allows the Federal Reserve to take into account netting arrangements for derivatives and securities transactions if they are fully secured by U.S. government securities or segregated deposits held by the bank.

Exemptions and the effect on the Board’s Rulemaking authority

- The Board’s authority to grant exemptions is now subject to a veto by the FDIC.

Volker Rule
The Sections 23A and 23B and Reg W refer to member banks (any national bank, state bank, banking association, or trust company that is a member of the Federal Reserve System), but the scope of coverage has been broadened so that if effectively applies to all banks that carry FDIC insurance and transactions between a US branch or agency of a foreign and any United States Financial Holding Company Affiliates.
Key Issues Covered in Section 23A

- What is an “affiliate” of a bank?
- What is a “covered transaction” with an affiliate?
- What are the quantitative limits on a bank’s covered transactions:
  - with any one affiliate; and
  - with all of its affiliates in the aggregate.
- What are the collateral requirements for a covered transaction?
  - Are there any exemptions to the collateral requirements?
- Is the bank following safe and sound banking practices?
Key Issues Covered Section 23B

- Is the covered transaction based on market terms?
  - Compare terms of similar transactions with unaffiliated entities.

- What are the Prohibited Transactions?
  - And the exceptions to a Prohibited Transaction.

- What are the restrictions on advertisements by a bank regarding an affiliate and the affiliates obligations?
To begin the analysis of a transaction that may be subject to Sections 23A and 23B of the FRA, there are two initial questions to ask:

- Is the transaction between the bank and an affiliate of the bank?
- Is the transaction between the bank and its affiliate a covered transaction?

If the transaction does not involve an affiliate or a covered transaction as provided in the FRA, then Section 23A does not apply.
The definition of covered transaction is found in Section 23A(b)(7) of the FRA (12 U.S.C. §371c). The definition of covered transaction in Reg W (12 C.F.R. §223.3(h)) reflecting the DFA amendments have not yet been enacted.

The seven categories of what constitutes a “covered transaction” with an affiliate by a bank are:
1. a loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase;

2. a purchase of or an investment in securities issued by the affiliate;

3. a purchase of assets from the affiliate, except such purchase of real or personal property as may be specifically exempted by the Board by order or regulation;
Analysis of the Transaction - Covered Transaction

4. the acceptance of other securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit to any person or company;

5. the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate,

6. a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate; or
7. a derivative transaction, as defined in paragraph (3) of Section 5200(b) of 12 U.S.C. §84(b), with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.
The Attribution Rule is found in 12 C.F.R. §223.16. The Attribution Rule prevents a bank from evading Section 23A by using intermediaries. The Attribution Rule requires that the bank must follow the money in its transactions. If any of the proceeds of a transaction with a customer of an affiliate are used for, or are transferred to the affiliate, then the bank has engaged in a covered transaction that is subject to the restrictions of Section 23A.
Exemptions to Attribution Rule

There are four exemptions to the Attribution Rule:

1) Riskless principal transactions
2) Brokerage commissions, agency fees, and riskless principal markups
3) Preexisting lines of credit
4) General purpose credit card transactions
The exemptions to covered transactions is found in Section 23A(d)(1)-(7) of the FRA (12 U.S.C. §371c(d)(1)-(7)) as implemented in Reg W at 12 C.F.R. §§223.41, 223.42, and 223.43.

- §223.41 – deals with exemptions from quantitative limits and collateral requirements
- §223.42 – deals with exemptions from quantitative limits, collateral requirements, and the low-quality asset prohibition
- §223.43 – deals with the Board’s rulemaking power to grant exemptions
Exemptions - 12 C.F.R. §223.41

Lists covered transactions that are exempt from quantitative limits and the collateral requirements listed in Reg W. However, there is no exemption from the safety and soundness requirement or the prohibition against the purchase of a low-quality asset. The exemptions are:

1) Parent-Subsidiary transactions – 80% threshold
2) Sister Bank Exemption – 80% threshold
3) Non-recourse purchase of loans from an affiliated depository institution
4) Internal corporate reorganizations – seven conditions must be met
Lists covered transactions that are exempt from quantitative limits, the collateral requirements, and the prohibition against purchasing low-quality assets provided in Reg W. As with the exemptions listed in 12 C.F.R. §223.41, there is no exemption from the safety and soundness requirement. The exemptions are:

1) Correspondent banking deposits – as defined in 12 U.S.C §1813
2) Giving credit for uncollected items received in the ordinary course of business
3) Transactions secured by United States government securities
Exemptions - 12 C.F.R. §223.42

4) Purchasing securities of a servicing affiliate – 12 U.S.C. §1843(c)(1)

5) Purchasing a liquid asset having a readily identifiable and publicly available market quotation that is purchased at a below the asset’s current market value.

6) Purchasing certain marketable securities

7) Purchasing municipal securities
Exemptions - 12 C.F.R. §223.42

8) Purchasing an extension of credit subject to a repurchase agreement
9) Purchase of an asset by a newly formed bank – if approved
10) Bank Merger Act approved transactions
11) Non-recourse purchase of an extension of credit from an affiliate (with five conditions)
12) In-trading extensions of credit
13) Riskless principal transactions
Upon a member bank’s request, the Board may grant an exemption to a transaction or relationship by regulation or order. The request must sent to the General Counsel of the Board and provide:

- a detailed description of the transaction;
- an explanation why the transaction or relationship should be exempt; and
- Explain why the exemption is in the public interest and consistent with the purposes of Section 23A.
Quantitative Limits

A bank may not engage in a new covered transaction with an affiliate if the aggregate amount of covered transactions between the insured amount of covered transaction is closed would be in excess of:

- 10 percent of the bank’s capital stock and surplus; with the affiliate involved in the new transaction; and
- The aggregate covered transaction between the insured bank and all affiliates exceeds 20 percent of the bank’s capital stock and surplus.
Covered Transaction – Extensions of Credit to an Affiliate

There are six general categories of an extension of credit listed in Regulation W (12 C.F.R. §233.3(o)):

1. An advance to an affiliate by means of an overdraft, cash item, or otherwise;
2. A sale of Federal funds to an affiliate;
3. A lease that is the functional equivalent of an extension of credit to an affiliate;
4. An acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other securities of an affiliate;

5. An 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

6. Any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent).
Extensions of Credit with an Affiliate – Buying an Affiliate’s Debt Securities

A bank’s purchase of an affiliate’s debt security is an extension of credit under Section 23A. The bank must collateralize the transaction. However, there is an exemption from the collateral requirement where the bank buys its affiliate’s debt securities from a third party in a bona fide secondary-market transaction.
One of the issues concerning covered transaction is the limits placed on the amount of the transaction, so the first question is how the credit extension is valued. The valuation is determined under a three prong test which is the greater of:

1) The principal amount of the credit extension; or
2) The amount owed by the affiliate to the member bank under the transaction; or
3) The sum of (a) the amount provided to, on behalf of, the affiliate in the transaction and (b) any additional amount the bank could be required to provide to the affiliate.
Indirect credit transactions occur if the bank buys a loan that a third party made to the bank’s affiliate. In an indirect credit transaction, the bank must value the extension of credit at the price paid to purchase the loan plus any additional amount the bank may have to fund under the extension of credit under the terms of the credit agreement purchased.
For purposes of Section 23A, the determination of when a credit transaction has been entered into is when the bank becomes legally obligated to make the extension of credit, not when the funds are actually advanced, or guarantee paid.

Reg W requires the bank to compute the compliance with quantitative limits when the bank is about to engage in a new covered transaction. 12 C.F.R. §223.21(b)(1).
Covered Transactions – Other Extensions of Credit

- **Leases**
  - Is the lease a functional equivalent of a loan?

- **Extensions of Credit Secured by Affiliate Securities**
  - General valuation rule – two situations
    - First situation: The loan is collateralized only by the affiliate’s securities.
      The covered transaction is valued at the full amount of the extension of credit, unless there is a ready market for the securities in which case the transaction may be valued at the fair market value of the securities.
Covered Transactions – Other Extensions of Credit

- Extensions of Credit Secured by Affiliate Securities
  - General valuation rule
    - Second situation: The loan is collateralized by the affiliate’s securities and other collateral.
      The covered transaction is valued at the lesser of the total value of the extension of credit minus the fair market value of the other collateral, or the fair market value of the affiliate’s securities if the securities have a ready market.
Covered Transactions – Other Extensions of Credit

- Extensions of Credit Secured by Affiliate Securities – Mutual Fund Shares
  - Exemption found in 12 C.F. R. §223.24(c)
Covered Transactions – Asset Purchases

- Valuation – What is the total amount of the consideration paid to purchase the asset? 12 C.F.R §223.22
  – Consideration includes an assumption of liabilities.
  – An asset purchase is always be a covered transaction until it is sold, but the valuation of the asset purchase may be reduced provided the amortization or depreciation of the asset is consistent with GAAP.
Be aware of exceptions

- The bank’s purchase of a loan made by one affiliate to a second affiliate is an extension of credit to the borrower. 12 C.F.R. §223.21
- The bank’s purchase of a securities owned by one affiliate and issued by a second affiliate is an investment in securities issued by the second affiliate. 12 C.F.R. §223.23
- The bank’s purchase of the shares of an affiliate that later becomes an operating subsidiary, then the bank values the transaction as provided in 12 C.F.R. §223.31
Valuation – the bank must value a purchase of, or an investment in, securities issued by an affiliate (not including securities issued by the bank’s financial subsidiary) at the greater of the bank’s purchase price or the carrying value of the securities. 12 C.F.R §223.23
Covered Transactions – Issuance of a Letter of Credit or Guarantee

- Letter of Credit – Includes the confirmation of a letter of credit issued by the affiliate. 12 C.F.R §223.3(h)(5).
- Guarantees
  - Supporting a Securities Underwriting
    - If a bank issues a guarantee in support of securities issues by a third party and underwritten by the bank’s securities affiliate, the guarantee is not deemed a covered transaction. The Attribution Rule has been held not to apply.
Covered Transactions – Issuance of a Letter of Credit or Guarantee

- **Guarantees**
  - Cross-Guarantees and Cross-Affiliate Netting Agreements
    - A cross-guarantee among the bank, its affiliate, and a non-affiliate third party where the third party can rely on the bank’s assets to satisfy the obligations owed to the third party is a covered transaction.
    - A cross-affiliate netting arrangement where a non-affiliate is involved and the non-affiliate may offset the obligations it owes to the bank with the obligations the affiliate owes the non-affiliate.

- **Keepwell Agreements**
The general rule is that a bank cannot purchase a ‘low-quality asset” from an affiliate. 12 U.S.C. §371c(a)(3); 12 C.F.R §223.15(a).

A “low-quality asset” is an asset that is –
  – a classified asset according to a recent examination
  – a nonaccrual asset
  – an asset where payments are greater than 30 days past due
  – an asset that has been renegotiated due to poor debtor financial condition (for example, a loan with a forbearance agreement)
  – an asset that is included in Other Real Estate Owned
Be aware of the expansion of what a low-quality asset is under Reg W.

Exceptions to the prohibition

- A purchase is allowed if the bank completed an independent credit evaluation of the asset and committed to purchase the asset prior to the affiliate’s acquisition. 12 U.S.C. §371c(a)(3).
- Loan participation exception - 12 C.F.R. §223.15(b).
Covered Transactions – Borrowing or Lending of Securities

- Securities lending transactions to the extent it causes the bank to have credit exposure is added as a covered transaction under DFA.
- Question is how to quantify the bank’s credit exposure to add to the quantitative limits of Section 23A.
Covered Transactions - Derivatives

- Added as a covered transaction through DFA.
- Requires banks to evaluate the credit exposure to the bank and add that amount to the quantitative limits of Section 23A and establish policies and procedures to monitor the exposure.
- Policies in place to impose credit controls and collateral requirements.
Section 23B of the FRA (12 C.F.R. §223.51)

- Requires all covered transactions and certain other transactions be on market terms.
- The other transactions include:
  1) Sale of assets by the bank to an affiliate
  2) Payment of money or furnishing of services by the bank to an affiliate
  3) Transaction where an affiliate acts as agent or broker for the bank or any other person of the bank is a participant in the transaction
  4) Transaction by the bank with a third party if an affiliate has an interest in the third party or the affiliate is a participant in the transaction.
Section 23B
(12 C.F.R. §223.51)

- Market Terms – both require comparable credit standards
  1) If there is a market, then the terms must be on the same terms or at least as favorable to the bank as the terms prevailing at the time for comparable transactions with or involving unaffiliated entities.
  2) If there is no market, then terms must be at least as favorable to the bank offered in good faith to unaffiliated entities.