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# Bank Affiliate Transactions: Navigating Regulation W, Sections 23A and 23B of the Federal Reserve Act

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# Bank Affiliate Transactions – Sections 23A and 23B of the Federal Reserve Act and Federal Reserve Regulation W

May 16, 2017


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# Overview

- Sections 23A and 23B of the Federal Reserve Act limit the risks to banks from transactions with affiliates and limit the ability of banks to transfers their federal subsidy to affiliates (Reg. W  Release adopting Final Rule (Nov. 27, 2002) (the "Reg. W Adopting Release").
- Section 23A was adopted as part of the Banking Act of 1933, which also:
  - Established the FDIC and deposit insurance, and prohibited the payment of interest on demand deposits and limited rates payable on deposits.
  - Included the Glass – Steagall Act separating commercial and investment banking.
  - Established margin lending restrictions on securities.

# Overview (continued)

- Amended by the Gramm-Leach Bliley Act (1999) ("GLB Act") and the Dodd-Frank Act (2010), among others.
- Imposes quantitative limits on "covered transactions" between a member bank and its "affiliates"

# Overview (continued)

- Section 23B of the Federal Reserve Act
  - Adopted by the Competitive Equality Banking Act of 1987 and the GLB Act and the Dodd-Frank Act.
  - Imposes qualitative limits on transactions between a member bank and its “affiliates.”
  - “Market terms” include terms and circumstances that are substantially the same or at least as favorable as those prevailing at the time for comparable transactions with non-affiliates. Reg. W  Adopting Release.

# Overview (continued)

- Section 18(j) of the Federal Deposit Insurance Act (the "FDI Act") makes Sections 23A and 23B equally applicable to state non-member insured banks.
  - Generally does not apply to U.S. branches of foreign banks.
- The Home Owners Loan Act (12 U.S.C. 1461) ("HOLA")
  - HOLA, Section 10(d) – transactions with affiliates are subject to HOLA, Section 11's prohibitions and limitations.
  - HOLA, Section 11 generally makes Sections 23 and 23B applicable to savings associations in the same manner as member banks.

# Overview (continued)

- Reg. W, § 223. 72 implements HOLA, Section 11.
  - Every savings association shall be treated as a bank for purposes of Section 23A (d)(1)(pre-committed purchases of same quality assets) and Section 23B.
- The appropriate federal banking agency may impose additional restrictions on affiliate transactions to protect bank safety and soundness.

# Overview continued

- The Federal Reserve Board's (the "Federal Reserve") Regulation W ("Reg. W") implements Sections 23A and 23B of the Federal Reserve Act.
- Reg. W interprets and applies Sections 23A and 23B and is applicable to all member banks.
- Regulation W provides a single, comprehensive reference tool for complying with and analyzing issues arising under sections 23A and 23B. The regulation restates the statutory definitions, restrictions, and exemptions, and also includes Federal Reserve interpretations of the sections.

# Overview continued

- Reg. W has 8 subparts:
  - -- Subpart A -- comprehensive glossary of the terms
  - -- Subpart B -- principal restrictions and requirements imposed by Section 23A
  - -- Subpart C -- appropriate valuation and timing principles for covered transactions
  - -- Subpart D -- appropriate treatment under Section 23A of transactions with financial subsidiaries, bank-affiliate derivative transactions, and certain bank-affiliate merger and acquisition transactions

# Overview continued

- Reg. W has 8 subparts (continued):
  - -- Subpart E -- available exemptions from certain Section 23A requirements
  - -- Subpart F -- operative provisions of section 23B
  - -- Subpart G -- the application of Sections 23A and 23B and Reg. W to U.S. branches and agencies of foreign banks
  - -- Subpart H -- miscellaneous Federal Reserve interpretations of Sections 23A and 23B

# What is an Affiliate?

- An “affiliate” is broadly defined in Reg. W, § 223.2(a) as any company that is owned or “controlled” by a company that owns the bank, including
  - A parent holding company, including companies that control the bank, or companies that are controlled by shareholders that control the bank, and all the subsidiaries of the company, including depository institutions subsidiaries
  - Companies controlled by a parent BHC or under common control with the bank
  - Companies with interlocking directors
  - Financial subsidiaries of the bank
  - Portfolio companies held 15% or more by a BHC under its merchant banking authority or insurance company investment authority

# What is an Affiliate? (continued)

- Entities sponsored or advised by the bank, including REITS and investment companies.
- Any unregistered investment fund for which the bank or any affiliate of the bank serves as an investment advisor, if the bank and its affiliates own or control in the aggregate more than 5% of any class of voting securities or more than 5% of the fund's equity capital
- An insured depository institution subsidiary 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.

# What is an Affiliate? (continued)

- Subsidiaries of affiliates.
- Any company that the Board determines by regulation or order, or that the appropriate Federal banking agency for the bank determines by order, to have a relationship with the bank, or any affiliate of the bank, such that covered transactions by the bank with that company may be affected by the relationship to the detriment of the bank.

# What is "Control"?

- "Control" is defined in Reg. W, § 223.3(a) based on the Federal Reserve's long-standing precedents under Regulation Y, as well as Regulation W
  - ≥ 25% of voting securities
  - ≥ 25% of the equity capital
  - General partner/managing member
  - Ability to select majority of directors
  - Controlling influence over management or policies
  - Management interlocks
  - Convertible securities – deemed to represent the underlying securities into which they are convertible
  - A company is deemed to control assets, securities and ownership interests controlled by any subsidiary of the company

# What is "Control"? (continued)

- Control is interpreted similarly under the Bank Holding Company Act and Federal Reserve Regulations Y, O and W.
- Notwithstanding any other provision of Reg. W, no company will be deemed to control another company by virtue of its ownership or control of shares in a fiduciary capacity, except as provided in Reg. W, §223.2(a)(3)
- Reg. W, § 223.2(a)(3) describes a company (including a bank subsidiary) 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), or if the company owning or controlling the shares is a business trust.

# Entities Not Considered Affiliates

- Subsidiaries of the bank, except for –
  - Financial subsidiaries and their subsidiaries
  - Companies controlled directly by an affiliate or shareholder or group of shareholders that control the bank
  - Depository institutions
  - Employee Benefit Plans, ESOPs, trusts, or similar arrangements that benefit shareholders, partners, members or employees of the bank or its affilaites
- Sister banks (80% or more common control)
  - For Section 23B purposes, “affiliate” does not include depository institutions (Reg. W, § 223.2(c) and Subpart F, which implements Section 23B
- Safe deposit companies

# Entities Not Considered Affiliates (continued)

- Companies engaged solely in holding obligations of, or fully guaranteed as to principal and interest by, the U.S. government or its agencies
- Bank premises companies
- Subsidiaries holding assets etc. as a result of debts previously contracted in good faith ("DPC")
- DPC subsidiaries
- Bank premises companies

# What are Covered Transactions?

- "Covered Transactions" are defined in Reg. W, § 223.3(h), and include:
  - A loan or extension of credit to an affiliate;
  - A purchase of, or an investment in securities issued by an affiliate;
  - A purchase of assets from an affiliate, including assets subject to recourse;
  - The acceptance of securities or debt obligations issued by an affiliate as collateral for a loan or extension of credit;
  - The issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate, and a confirmation of a letter or credit issued by an affiliate.
  - A cross-affiliate netting agreement, including an endorsement or standing letter of credit, as defined in Reg. W., § 223.3(j);

# What are Covered Transactions? (continued)

- A securities lending or borrowing transaction with an affiliate to the extent the transaction causes a bank or a bank subsidiary to have credit exposure to an affiliate;
- A derivative transaction with an affiliate to the extent the transaction causes a bank or a bank subsidiary to have credit exposure to the affiliate; and
- “Keep well” or capital maintenance agreements on behalf of affiliates.

# What are Covered Transactions? (continued)

- "Extensions of credit" to affiliates are broadly defined in Reg. W, §223.3(o) and include the making or renewal of a loan, the granting of a line of credit, or the extending of credit in any manner whatsoever, including on an intraday basis.
- Further extensions of credit to an affiliate, include:
  - An 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 an affiliate;

# What are Covered Transactions? (continued)

  - An acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other 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).
- Reg. W, § 223.16 treats "transactions with any person as a transaction with an affiliate to the extent the proceeds of the transaction are used for the benefit of, or are transferred to an affiliate."

# Section 23A – Limits on Covered Transactions

- **Quantitative Limits**— Reg. W, § 223. limits covered transactions to:
  - 10% of the bank's "capital and surplus" with one affiliate, other than with the bank's own financial subsidiaries
  - 20% of the bank's capital and surplus with all affiliates and financial subsidiaries in the aggregate
- "Capital and surplus" refers to regulatory capital with certain adjustments:
  - The bank's tier 1 and tier 2 capital based on the bank's most recent Call Report; *plus*
  - The balance of the bank's allowance for loan and lease losses not included in tier 2 capital based on the bank's most recent Call Report; *plus*

# Section 23A – Limits on Covered Transactions (continued)

- 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 the bank's capital for regulatory capital purposes.

# Section 23A – Limits on Covered Transactions (continued)

- **Collateral Requirements** – extensions of credit to an affiliate by a bank must be fully collateralized at the time of the transaction by a first priority perfected security interest in "eligible collateral" under Reg. W, § 223.
- Eligible collateral as a percentage of the credit extended:
  - U.S. governmental and agency securities or securities fully guaranteed thereby as to principal and interest - - 100%
  - Notes, drafts, bill of exchange or bankers' acceptances eligible for purchase or rediscount by a Federal Reserve Bank - - 100%
  - A segregated, earmarked deposit account with the bank that solely secures the affiliate's credit transaction with the bank – 100%

# Section 23A – Limits on Covered Transactions (continued)

- Obligations of states and political subdivisions - - 110%
- All other debt obligations, including loans and receivables - - 120%
- Stocks, leases, realty or personalty 130%

# Section 23A – Limits on Covered Transactions (continued)

- **Exceptions from the Collateral Requirements**
  - Acceptances that are fully secured either by attached documents or by other property that is involved in the transaction and has an ascertainable market value;
  - The unused portion of an extension of credit to an affiliate where the bank does not have any legal obligation to advance additional funds until the affiliate provides the amount of collateral required with respect to the entire used portion of the credit (including the amount of the requested advance); and
  - The purchase of a debt security issued by an affiliate, if the member bank purchases the debt security from a nonaffiliate in a bonafide secondary market transaction.

# Section 23A – Limits on Covered Transactions (continued)

- **Ineligible collateral includes:**
  - 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;
  - Intangible assets (including servicing assets), unless specifically approved by the Board; and
  - Guarantees, letters of credit, and other similar instruments.

# Section 23A – Limits on Covered Transactions (continued)

- **Timing and Validation** - - The timing and valuation of covered transactions are specified in Reg. W, §§ 223.21–24 and vary depending upon whether the transaction is
  - an extension of credit,
  - an asset purchase of or investment in affiliate securities, or
  - an extension of credit secured by affiliate securities.
- For example:
  - 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 Reg. W are met “promptly” after the nonaffiliate becomes an affiliate.

# Section 23A – Limits on Covered Transactions (continued)

- Even though a  purchase of or an 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.
- 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 such securities have publicly available price quotes.

# Section 23A – Limits on Covered Transactions (continued)

- 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 such securities have publicly available price quotes. Under this rule, the maximum amount that the bank must count against Reg. W's quantitative limits is the difference between the full amount of the loan and the fair market value of the nonaffiliate collateral.

# Section 23A – Limits on Covered Transactions (continued)

- **Low Quality Asset Prohibition –** banks may not purchase "low quality assets" from an affiliate, and low quality assets may not serve as collateral for a loan from the bank to an affiliate
- "Low Quality Assets" are:
  - An asset (including a security) classified as "substandard," "doubtful," or "loss," or treated as "special mention" or "other transfer risk problems," either in the most recent report of examination or inspection of an affiliate prepared by either a Federal or State supervisory agency or in any internal classification system used by the bank or its affiliate (including an asset that receives a rating that is substantially equivalent to "classified" or "special mention" in the bank's or its affiliate's internal system of the member bank or affiliate);
  - A nonaccrual asset;
  - An asset on which principal or interest payments are more than thirty days past due;

# Section 23A – Limits on Covered Transactions (continued)

  - An asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor; and
  - An asset acquired through foreclosure, repossession, or otherwise in satisfaction of a debt previously contracted, if the asset has not yet been reviewed in an examination or inspection.

- **Qualitative Limitations** – all transactions (not just covered transactions) must be on terms and conditions consistent with safe and sound banking practices

# Covered Transactions-Attribution Rule

- The “attribution rule” of Reg. W, § 223.16 is designed to prevent banks from evading Section 23A’s requirements by using intermediaries
- The Attribution Rule applies Section 23A when a bank is engaged in a transaction with a non-affiliate, but where the proceeds of the transaction are transferred to or used for the benefit of the affiliate
- Any transactions excepted from the Attribution Rule are subject to Reg. W’s safety and soundness market terms requirements

# Section 23A – Exemptions

- The following are generally exempt from the quantitative limitations and collateral requirements (but not the low-quality asset prohibitions):
  - Transactions with sister, parent or subsidiary banks that are commonly owned 80% or more;
  - Purchase of loans on a nonrecourse basis from an affiliated bank; and
  - Transactions approved in connection with certain corporate reorganizations.

# Section 23A – Exemptions (continued)

- The following are generally exempt from the quantitative limitations, collateral requirements, and low-quality asset prohibitions:
  - Correspondent banking deposits;
  - Giving credit for uncollected items;
  - Transactions secured by cash or U.S. government securities;
  - Purchasing securities from a servicing affiliate;
  - Purchasing liquid assets, marketable securities, and muni securities;
  - Purchasing an extension of credit subject to a repo;
  - Asset purchases 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; and
  - Riskless principal transactions.

# Section 23B – Market Terms Requirements

- Reg W, §223.51 sets the "market terms" for Section 23B
- A bank may not engage in a transaction described in §223.52 unless the transaction is:
  - on terms and under circumstances, including credit standards that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with or involving nonaffiliates; or
  - in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliates.

# Dodd-Frank Act Affiliate Transactions Restrictions

- Section 608 of the Dodd-Frank Act imposes additional restrictions on bank affiliate transactions
  - Expands the definition of "Affiliate"
    - Any "investment fund" for which a bank or its affiliates is an "investment adviser" is an affiliate
  - Expanded definition of "Covered Transaction"
    - Derivative transactions and securities lending and borrowing transactions between a bank or its subsidiary are included "to the extent" that the transaction causes a credit exposure

# Dodd-Frank Act Affiliate Transactions Restrictions

- Super 23A and 23B -- Section 619 of the Dodd-Frank Act applies so-called “super” 23A and 23B restrictions to affiliated “covered funds” (as defined under the Volcker Rule)

# Super 23A and 23B

- A “banking entity” (as defined under the Volcker Rule) that advises, manages, sponsors, organizes or offers covered funds (and all of the banking entity’s affiliates) may not enter into a covered transaction with the “covered fund,” as defined in Volcker Rule, or with any other covered fund that is controlled by the covered fund
- As applied to covered funds and affiliated banking entities Section 23A prohibits banks from:
  - Extending credit to the covered fund;
  - Purchasing or investing in securities issued by the covered fund;
  - Purchasing assets from the covered fund;
  - Accepting securities issued by the covered fund as collateral for a loan or extension of credit to any person; and
  - Issuing a guarantee, acceptance, or letter of credit on behalf of the covered fund.
- All other transactions between a banking entity and an affiliated covered fund are subject to Section 23B’s market terms requirements

# Why Is This Restriction Called "Super " 23A and 23B?

- Under usual Section 23A, banks may generally engage in covered transactions, subject to certain quantitative and qualitative limits.
  - Super 23A prohibits all covered transactions between banking entities and affiliated covered fund
- Sections 23A and Section 23B generally apply to banks and their subsidiaries only. They do not place prohibitions on other affiliates of the member bank
  - Super 23A and 23B greatly expand the restrictions on transactions to all affiliates of a "banking entity" as if these were banks

# Scenario 1 – Collateral

- An affiliate of a bank maintains a checking account at the bank that the affiliate uses to pay certain obligations. The balance of the account never falls below $100,000. Can that account be used as collateral for an extension of credit up to $100,000?

# Scenario 2 – Covered Transactions

- An affiliate of a bank has a checking account that went into an overdraft position of $10 over one night because of the bank's funds availability policy. The affiliate had sufficient balances but not sufficient available balance. Is this a violation of Regulation W?

# Scenario 3 – Low Quality Assets

- A bank has decided to consolidate some of its financial subsidiaries into the bank to reduce expenses. One of the subsidiaries has a loan portfolio that contains classified or criticized loans, loans that are more than 30 days delinquent or loans that have been renegotiated. Can the bank merge the subsidiary into the bank?

# Scenario 4 – Low Quality Assets

- A bank has decided to consolidate some of its financial subsidiaries into the bank to reduce expenses. One of the subsidiaries has assets on its books that it acquired through foreclosure, repossession or other similar activity. Can the bank merge the subsidiary into the bank?

# Scenario 5 – Covered Transactions

- A bank has made loans to its customers taking a security interest in their brokerage account. The brokerage account has stock of the bank's holding company. Is this a problem?
- Can the bank loan money secured by affiliate stock?

# Scenario 6 - Affiliates

- A bank has been buying mortgage loans from an unaffiliated mortgage company for years. The principals of the mortgage company are approaching retirement age and have made inquiry of the bank about whether the bank would be interested in acquiring the mortgage company from them. The bank is desirous of maintaining the pipeline of mortgages and indicates that it is interested. Can the parties continue their relationship while negotiating the acquisition?

# Scenario 7 – Underwriting

- The bank has an affiliated broker-dealer that underwrites securities. The broker-dealer is involved in underwriting a stock offering for a tech company that is in high demand. All of the analysts are strongly recommending investors try to get their hands on the stock in this IPO. Can the bank, as a fiduciary for some of the accounts that it acts as trustee, acquire this stock in the IPO?
- A bank affiliate is a member of an underwriting syndicate that is making a public offering of debt securities that the bank believes will be an attractive investment for the bank's own portfolio. Can the bank buy the securities for its own account?
- Can the bank finance customer purchases of these debt securities?

# Scenario 8 – Underwriting, etc.

- A bank has an affiliated broker-dealer that is a financial subsidiary of the same parent bank holding company. The broker-dealer arranges a syndicated loan in which the bank is the lead lender and simultaneously underwrites an issue of high yield debt securities. The markets change and the broker-dealer is left holding unsold high yield securities. Can the bank buy these or finance a customer's purchase of the high yield securities?
- Same scenario, except the broker-dealer did not engage in a public underwritten offering of the high yield securities, but instead offered these pursuant to SEC Rule 144A?
- Can a bank issue a letter of credit or a guarantee with respect to securities underwritten by the broker-dealer?

# Scenario 9 – Covered Transactions

- Bank has a family of mutual funds that it sponsors and invests funds from some of its fiduciary accounts. The money market fund in this family of mutual funds is potentially going to "break the dollar." Can the bank contribute money in the money market fund so as to have it avoid breaking the dollar?

# Scenario 10 - Agency and Riskless Principal Transactions

- A broker-dealer affiliate often sells securities in private placements or as riskless principal in secondary market transactions. Can the bank buy such securities or finance its customers‘ purchases of such securities?
- Can the bank finance secondary market purchases of debt issued by the bank’s affiliates?

# Scenario 11 -- Subsidiaries

- Can a bank buy assets from or extend credit to a subsidiary of the bank?
- What if the subsidiary is a 50-50 joint venture?
- What if the bank owns less than 50% of the subsidiary?

# Scenario 12 - Companies Acquired DPC

- Can credit be modified or renewed, or can new credit be extended to a company that is controlled by the bank as a result of the bank's exercise of its remedies as creditor under a debt previously contracted in good faith ("DPC")?
- What if the lender bank does not own 100% of the DPC company?

# Scenario 13 - Advertisements

- Can a bank publish an advertisement or enter into an agreement stating or suggesting that the bank will be in any way responsible for the obligations of its affiliates?

# Scenario 14 – Corporate Reorganization

- The parent of a bank is reorganizing and proposes to sell or transfer all or substantially all assets of an affiliate and of a division of another affiliate, including securities issued by an affiliate to a bank subsidiary. Is this permissible?

# Thank You

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