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Affiliate Transaction Restrictions for Banks: Your Guide to the Requirements

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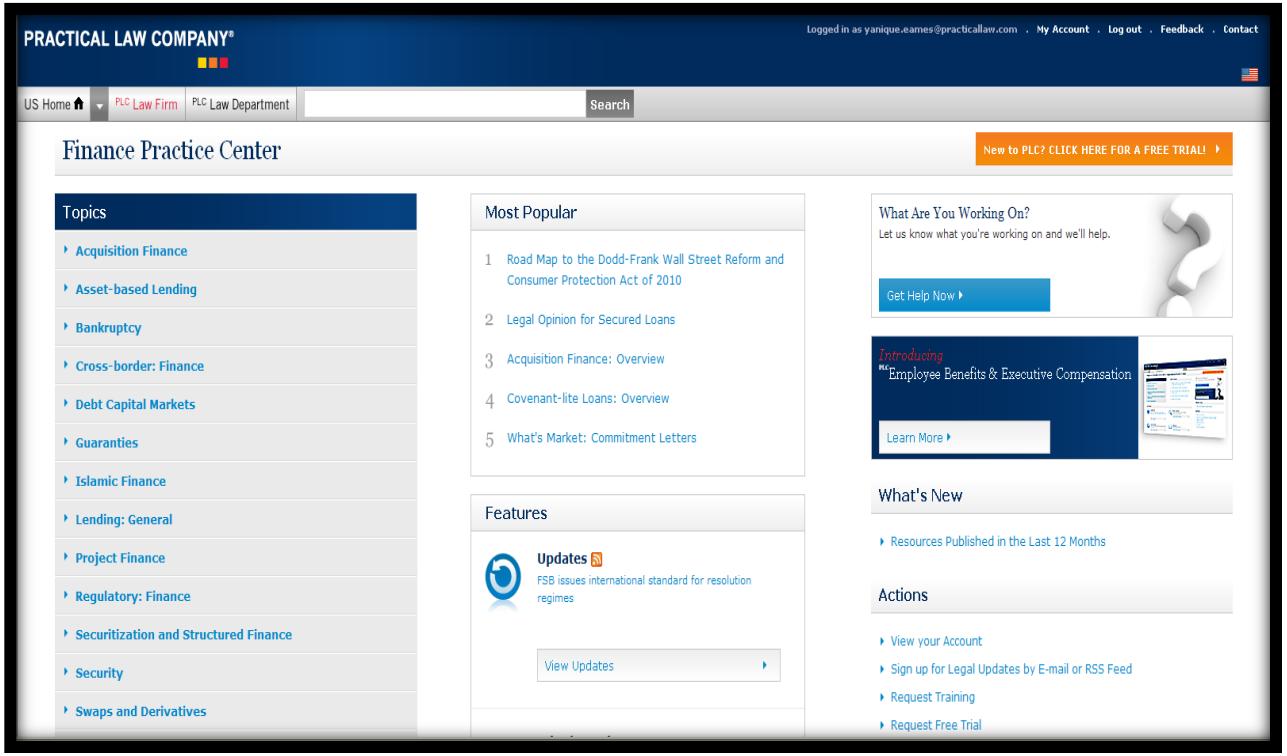

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Overview

- What are Section 23A and Section 23B of the Federal Reserve Act?
- When do these statues apply?
- Who is and who is not an "Affiliate"?
- What transactions are "covered" by, and what transactions are exempt from, Section 23A and Section 23B?
- What are the limits on affiliate transactions?
- What changes did the Dodd-Frank Act make to the affiliate transaction requirements?

What are Section 23A and Section 23B?

- Impose prudential limitations on transactions between depository institutions and their affiliates:
  - Intended to protect depository institutions from misuse of their resources in transactions with their affiliates
  - Limit the ability of depository institutions to transfer to affiliates the subsidy arising from access to the Federal safety net (insured deposits, the payment system, and the discount window)
- Implemented by the Federal Reserve Board's Regulation W
  - Regulation W took effect April 1, 2003. It defines terms in the statute, explains the statute's requirements, prescribes valuation rules, and exempts certain transactions
  - Federal Reserve Board recently adopted a new Subpart I of Regulation W relating to savings associations

When do Section 23A and Section 23B Apply?

- Three factors must be present:
  - A "bank" or one of its subsidiaries is a party to the transaction
  - An "affiliate" of the "bank" is a party to the transaction (or benefits from the transaction)
  - The transaction is "covered" by Regulation W

When do Section 23A and Section 23B Apply?

- Other key points
  - Transactions between a bank and its own subsidiary are generally not subject to Regulation W
  - Transactions between two affiliates are generally not subject to Regulation W
    - "Super 23A" requirement of Volcker Rule
  - Transactions between two insured institutions may be subject to some (but not most) requirements

When do Section 23A and Section 23B Apply?

- Section 23A and Section 23B apply to ***all types of depository institutions***:
  - By their terms, Section 23A and Section 23B of the Federal Reserve Act and Regulation W apply to banks that are members of the Federal Reserve System
    - National banks
    - State member banks
  - Section 18(j) of the Federal Deposit Insurance Act makes Section 23A and Section 23B applicable to all state chartered non-member banks
    - State nonmember banks, including industrial banks
  - Section 11 of the Home Owners Loan Act makes Section 23A and Section 23B applicable to all savings associations
    - Additional restrictions apply to savings associations
  - Applies to certain transactions involving a U.S. branch or agency of a foreign bank

What is an affiliate?

- Parent holding company
- Companies controlled by the parent holding company or under common control
- Insured depository institutions are treated as affiliates for some purposes (but entitled to exemptions for most transactions)
- Companies with interlocking directorates
- Financial subsidiaries
- Companies held under merchant banking or insurance company investment authority
  - Subject to certain presumptions
- Partnerships
- Subsidiaries of affiliates
- Other companies specified by the Federal Reserve Board

What is an affiliate?

- Companies controlled by and under common control with parent holding company:
  - 25% or more of class of voting securities (including convertible securities)
  - General partner of partnership
  - Manager of LLC
  - 25% or more of equity capital
  - Ability to select majority of directors
  - Ability to exercise "controlling influence"
  - Control can exist at lower thresholds through management interlocks, management agreements, restrictions on transfer, voting agreements, etc.

What is an affiliate?

- Currently, investment funds may be affiliates:
  - Investment company advised or sub-advised by a bank or its affiliates
  - "Sponsored" and advised companies
    - No definition of "sponsored" but probably includes companies with a similar name that the bank or an affiliate organized and/or promotes
  - Investment fund advised by a bank or an affiliate if the bank or affiliate owns more than 5% of any class of voting securities or of the equity of the fund
- Effective July 21, 2012:
  - Section 608(a) of the Dodd-Frank Act amends the definition of "affiliate" so that it includes any "investment fund" with respect to which a bank or an affiliate is an investment adviser
  - "Super 23A" provision of Volcker rule applies affiliate transaction restrictions to certain covered funds

What is an affiliate?

- Exceptions from "affiliate" status
  - Bank subsidiaries, except for:
    - Financial subsidiaries
    - Companies directly controlled by an affiliate or a shareholder or group of shareholders that control the bank
    - Depository institutions (except for 23B purposes)
    - Employee stock option plan, trust or similar arrangement that benefits shareholders, partners, members or employees of the bank or its affiliates
  - Safe deposit companies
  - Companies engaged solely in holding obligations of or guaranteed by the U.S. government or its agencies as to principal and interest
  - Bank premises companies
  - Companies held DPC

What is a covered transaction?

- Transactions where a bank actually or potentially provides money to or on behalf of an affiliate:
  - Making a loan or extension of credit to an affiliate
    - Effective July 21, 2012, will include repurchase transactions (currently treated as asset purchase covered transactions)
  - Providing a guarantee on behalf of an affiliate or confirming a letter of credit issued by an affiliate
  - Purchasing assets from an affiliate
  - Purchasing securities issued by an affiliate
  - Accepting affiliate issued securities as collateral for a loan
    - Effective July 21, 2012, includes accepting any affiliate debt obligation as collateral for a loan

What is a covered transaction?

- Effective July 21, 2012, securities lending/borrowing transactions and derivatives transactions will be treated as covered transactions "to the extent the transaction causes a . . . bank . . . to have credit exposure to the affiliate. . . ."
  - Securities lending transactions currently treated as a covered transaction under Federal Reserve Board precedent
  - The credit exposure arising out of derivatives transactions is not currently treated as a covered transaction if certain requirements are met.
- Section 608(a) of the Dodd-Frank Act will permit the Federal Reserve Board to issue interpretations 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

What is a covered transaction?

- Other kinds of extensions of credit:
  - Failure by an affiliate to make timely payment for services
  - Purchasing a loan from an affiliate with affiliate provided recourse
  - Overnight overdraft
  - Credit derivatives on affiliate obligations
  - Cross-Affiliate Netting Arrangement
  - Securities lending/borrowing (where bank lends securities to an affiliate or borrows securities and posts cash or securities collateral)

What is a covered transaction?

- "Attribution" Rule
  - Transaction with any person is deemed to be a transaction with an affiliate if:
    - Proceeds transferred to an affiliate
    - Proceeds used for the benefit of an affiliate
  - The attribution rule can apply when a bank and an affiliate both make loans to the same borrower
  - General purpose credit card exception
  - Exception for certain brokerage fees/riskless principal markup
- The bottom line: Follow the money

Limitations on covered transactions

- A bank may **NOT** enter into a "covered" transaction if:
  - The aggregate amount of "covered" transactions outstanding between the Bank and ***any one affiliate*** would exceed 10% of the Bank's capital and surplus
    - Currently, Gramm-Leach-Bliley Act financial subsidiaries are not subject to this requirement
    - Effective July 21, 2012, financial subsidiaries will be subject to this requirement prospectively
  - The aggregate amount of "covered" transactions outstanding between the Bank and ***all affiliates*** would exceed 20% of a Bank's capital and surplus in the aggregate
  - An open-ended guarantee violates these limitations

Limitations on covered transactions

- Section 23A requires that loans to affiliates be collateralized
  - The amount of collateral depends upon the type:
    - 100%-Cash and Treasury Securities
    - 110%-Obligations of States and their political subdivisions
    - 120%-Other debt obligations (receivables, commercial paper)
    - 130%-Stock, leases, other real or personal property

Limitations on covered transactions

- A bank makes a $1,000 loan to an affiliate. The affiliate posts as collateral for the loan $500 in U.S. Treasury securities, $480 in corporate debt securities, and $130 in real estate:

Collateral Type	**Loan Amount**	**Factor**	**Requirement**
- Treasuries	$ 500	100%	$ 500
- Corp. Debt	$ 400	120%	$ 480
- Real Estate	$ 100	130%	$ 130
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Total	$1,000		$1,110

Limitations on covered transactions

- Ineligible Collateral
  - Affiliate issued securities
  - Letter of credit
  - Guarantee
  - Intangible assets
  - Low quality assets
  - Equity securities issued by the bank and debt securities issued by the bank that represent regulatory capital

Limitations on covered transactions

- Current/Historical Requirements
  - Generally based upon value of transaction at inception (generally, committed amount of loan)
  - The entire unused portion of a line of credit must be collateralized, unless:
    - The bank does not have a legal obligation to advance funds until the affiliate provides collateral
    - The affiliate provides the required amount of collateral (must "top off" collateral for prior advances)
  - Retired or amortized collateral must be replaced (but generally no need to "top off" collateral that simply declines in value)
  - A renewal or rollover is treated as a new extension of credit
- Effective July 21, 2012, Section 608(a) of Dodd-Frank Act amends Section 23A so that it will require that the required amount of collateral be maintained "***at all times***"

Limitations on covered transactions

- Prohibition on bank purchasing "low quality assets"
  - Assets classified as "substandard," "doubtful," "loss," "special mention" or similar classification
  - Nonaccrual assets
  - Past due more than 30 days
  - Renegotiated assets (due to deteriorating condition of obligor)
  - Assets acquired through foreclosure (unless the asset has been examined by bank examiners)
  - Applies to bank-to-bank transactions
  - Exception applies if bank makes an independent credit evaluation ***BEFORE*** the affiliate acquired the asset

Limitations on covered transactions

- All covered transactions and other transactions must be consistent with ***safe and sound banking practices***

Limitations on covered transactions

- Savings associations are subject to additional restrictions
  - Investments in affiliates (other than subsidiaries) are not permitted
  - Extension of credit to an affiliate engaged in any activity other than certain activities permissible for a bank holding company is not permitted
    - Historically, the OTS did not attribute to a parent company activities conducted indirectly by a subsidiary
- Federal Reserve Board recently added Subpart I to Regulation W
  - Adopts the substance of former OTS regulation at 12 C.F.R. § 563.41, except:
    - Some nomenclature changes
    - Removes recordkeeping and notification requirements

Limitations on covered transactions

- "Super" Section 23A
  - Included in Volcker rule
  - Becomes effective July 21, 2012
  - Applies to any "covered fund" sponsored by a banking entity or for which a banking entity serves as investment manager or investment adviser
  - Applied as if the fund were an "affiliate" and the banking entity and each of its affiliates were a "member bank"
  - Prohibits a banking entity and its affiliates from entering into any transaction with the fund that would be a covered transaction
  - Applies even if the transaction would be permitted under Regulation W
  - Narrow exception for certain prime brokerage transactions

Exceptions from Section 23A

- Payment of dividends by a bank
- Sale of assets to an affiliate (subject to market terms)
- Purchasing loans on a nonrecourse basis from an affiliated depository institution
- "Sister bank" exemption
  - 80% ownership
  - Subject to prohibition on purchasing low quality assets
- Credit for uncollected items
- Correspondent banking deposits
- Liquid assets
- Marketable securities
- Municipal securities
- Purchasing an extension of credit subject to a repurchase agreement

Exceptions from Section 23A

- Asset purchase by a newly formed bank
- Transactions Approved under the Bank Merger Act
  - Must involve insured depository institutions
- Purchasing an extension of credit originated by an affiliate
  - "250.250" exemption
- Intraday extensions of credit
- Riskless principal transactions
- Corporate reorganization transactions
  - Step transactions

Section 23B of the Federal Reserve Act

- Covered transactions and other transactions in which a bank pays money or furnishes services to an affiliate must be on "market terms"
  - The transaction must be conducted 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 or involving non-affiliated companies
  - In the absence of comparable transactions, the transaction must be on terms and under circumstances, including credit standards, that in good faith would be offered to or would apply to non-affiliated companies
- Market terms requirement applies to most transactions with affiliates:
  - Sales of assets to affiliates
  - Service Agreements
  - Entities/transactions in which an affiliate has a financial interest

Section 23B of the Federal Reserve Act

- Additional Section 23B prohibitions:
  - Purchasing securities or any other assets from an affiliate as a fiduciary unless permitted by:
    - Governing instrument
    - Court order
    - Applicable law
  - Purchasing a security for which an affiliate is a principal underwriter during the existence of an underwriting or selling syndicate
    - Applies to principal and fiduciary purchases
    - Does not apply if purchase is approved in advance by a majority of the bank's entire board of directors based on a determination that the purchase is a sound investment irrespective of the fact that an affiliate is a principal underwriter
  - Advertisements or agreements suggesting that the bank will be responsible for the obligations of an affiliate
    - A guarantee that complies with Section 23A is permitted

Case-by-case exemptions

- Effective July 21, 2012, Section 608(a) of the Dodd-Frank Act eliminates the Federal Reserve Board's unilateral authority to grant Section 23A exemptions by order. However:
  - Exemptions from Section 23A by order remain possible by joint action of primary federal regulator, Federal Reserve Board and FDIC
  - The Federal Reserve Board may continue to grant Section 23A and Section 23B exemptions by regulation if FDIC does not object to the proposed exemptions
  - Section 23B does not permit exemptions by order (no change)

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