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**RECENT DEVELOPMENTS IN THE FEDERAL RESERVE'S  
SECTION 23A AND 23B  
TRANSACTIONS WITH AFFILIATES**

**INTRODUCTION**

Most bankers are keenly aware of the treacherous path they travel when engaging in transactions involving affiliates. It can be a rocky road on which bankers sometimes stumble or fall. As a result, it is important for bankers to keep abreast of current regulatory developments and how the banking agencies interpret and apply the law relating to affiliate transactions. In recent weeks, the Federal Reserve has announced several actions relating to transactions with affiliates. These include interim and proposed rules and interpretations relating to the extension of intraday credit (daylight overdrafts) to, and derivative transactions with, affiliates. The Fed also finalized several interpretations and exceptions that had been previously proposed, and is seeking public comment on a new regulation that would incorporate numerous formal and informal interpretations and rulings the Fed has made over the past fifty years in this area.

**SUMMARY OF SECTIONS 23A AND 23B**

The purpose of Sections 23A and 23B is to limit the financial exposure banks may have to their affiliates by limiting the ability of banks to fund affiliates or otherwise enter into transactions with affiliates on unfavorable terms.

*Section 23A of the Federal Reserve Act* provides that a federally-insured bank may not enter into "covered transactions" with an affiliate in an amount that exceeds 10 per cent of the bank's capital stock and surplus ("capital") or, engage in covered transactions with more than one affiliate, in an amount that exceeds 20 per cent of the bank's capital.

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The concept of a “covered transaction” is a broad one. It includes such transactions as:

- loans and other extensions of credit to an affiliate
- a purchase of securities issued by an affiliate
- a purchase of assets from an affiliate
- the acceptance of securities issued by an affiliate as collateral for a loan
- the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate

In addition, when a bank makes a loan or extension of credit to an affiliate, or issues a guarantee, acceptance or letter of credit on behalf of an affiliate, the transaction must be secured by collateral whose value ranges from 100 per cent to 130 per cent of the amount of the transaction, depending upon the type of collateral presented.

Section 23A also contains an “attribution rule,” which provides that a transaction with an unaffiliated party is deemed to be a transaction with an affiliate if the proceeds of the transaction are transferred by the unaffiliated party to the affiliate, or if the proceeds are used for the benefit of the affiliate.

In addition, a bank may not purchase low quality assets from an affiliate even within the limitations of Section 23A. Further, transactions with affiliates must be on terms that are consistent with safe and sound banking practices.

There are a number of exceptions to the rigid requirements of Section 23A. For example, the restriction does not apply to transactions between affiliated banks. It also does not apply to a loan where U.S. government securities are used to fully secure the loan. In addition, Section 23A does not apply to a bank’s purchase of an asset from an affiliate where the asset has a readily identifiable and publicly available market quotation, and the asset is purchased at that price.

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*Section 23 B of the Federal Reserve Act* provides that a bank may engage in covered and certain other transactions with its affiliates only:

- on terms that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with nonaffiliates, or
- in the absence of comparable transactions, on terms that in good faith would be offered to, or would apply to, nonaffiliated companies

In addition to covered transactions, Section 23B also applies to:

- the sale of securities or other assets to an affiliate
- the payment of money or the furnishing of services to an affiliate under contract, lease or otherwise
- any transaction in which the affiliate acts as an agent or broker or receives a fee for its services to the bank or another person
- any transaction with a third party in which the affiliate has a financial interest in the third party or is a participant

### **RECENT FEDERAL RESERVE ACTIONS**

The Gramm-Leach-Bliley Act required the Federal Reserve to address as covered transactions a bank's credit exposure arising out of derivative transactions and intraday credit (daylight overdrafts) between the bank and its affiliates. The Fed recently issued an interim rule to address these two areas.

#### ***Derivative Transactions***

The Fed stated that derivative transactions between a bank and its affiliates are subject to Section 23B. (Derivatives include instruments such as swaps, forwards and options involving currencies, interest rates, foreign exchange, commodities and equities.) Accordingly, banks will be required to comply with Section 23B when engaging in derivative transactions with affiliates. Banks should, therefore, ensure that such transactions are on market terms and conditions.

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With regard to Section 23A, the Fed indicated that while derivative transactions do not create current credit exposure for banks at the inception of the transaction, they may result in future risk exposure in view of the potentially volatile nature of derivative transactions. Nevertheless, the Fed concluded that it would not at this time apply the quantitative and collateral requirements of Section 23A to derivative transactions engaged in by banks with affiliates. Banks will, however, be required to establish policies and procedures reasonably designed to manage the credit exposure arising from derivative transactions with affiliates in a safe and sound manner. The policies and procedures must provide for monitoring and controlling the bank's credit exposure which arises from derivative transactions entered into with affiliates.

### ***Intraday Extensions of Credit***

The Fed also concluded that an intraday extension of credit by a bank to an affiliate is subject to Section 23B and, accordingly, must be conducted on market terms and conditions.

The Fed recognized that it would be extremely burdensome to banks if it were to apply Section 23A to daylight overdrafts of affiliates. The Fed stated that the benefits achieved by applying Section 23A to daylight overdrafts in the form of reduced credit exposure may not outweigh the additional costs imposed on banks. Accordingly, the Fed adopted an approach similar to that used with regard to derivatives. Banks will be required to maintain policies and procedures reasonably designed to manage the credit exposure arising from intraday extensions of credit to affiliates, including monitoring and controlling credit exposures.

### ***Additional Exceptions from Section 23A***

The Federal Reserve adopted several exceptions from the coverage of Section 23A for certain types of transactions.

#### ***Loans to Purchase Assets Through Affiliates***

The Fed determined that Section 23A does not apply to loans made by a bank to an unaffiliated party when the customer uses the loan proceeds to purchase a security or other asset from an affiliate that is acting as a broker or riskless principal if no portion of the loan proceeds are retained by the affiliate as a fee or commission. In order to facilitate these transactions, the Fed also announced an exception from Section 23A for the fees and commissions that result from such transactions. Accordingly, a bank may make a loan to an unaffiliated party who uses the proceeds to purchase an asset through an affiliate and pay a fee or commission to the affiliate.

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The amount of the fee or commission would, of course, be subject to the market test of Section 23B.

An additional exception from Section 23A was created by the Fed to permit banks to make loans to an unaffiliated person where the proceeds of the loan are used to purchase a security through an affiliate that is a broker-dealer registered with the Securities and Exchange Commission:

- where the affiliate is acting as a riskless principal, and
- the security is not issued or underwritten by, or sold out of the inventory of, an affiliate.

The Fed also authorized banks to make a loan to an affiliate if:

- the proceeds of the loan are used to purchase a security from or through an affiliate that is a broker-dealer registered with the SEC, and
- the loan is made under a preexisting line of credit that was not established in contemplation of the purchase of securities from or through the affiliate.

### *Loans to Purchase Assets From Affiliates*

As a result of the affiliation of banks with securities firms, many banks requested the Fed to permit them to purchase assets from their securities affiliates without the strict pricing requirements that would otherwise apply. In response to these requests, the Fed authorized banks to purchase securities from an affiliate that is a broker-dealer registered with the SEC if:

- the security has a “ready market,” as defined by SEC rules
- the security is eligible for a state member bank to purchase directly
- the security is not a low quality asset
- the security is not purchased during an underwriting, or 30 days after an underwriting, if an affiliate is an underwriter

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- the price of the security is quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks and the price paid is at or below the current market quote, and
- the security is not issued by an affiliate

## **REGULATION W**

In view of the growing significance of Sections 23A and 23B to banking organizations as a result of the Gramm-Leach-Bliley Act, the Fed concluded that it would be desirable to codify all of the rulings and guidance the agency has provided over the past 50 years. Accordingly, the Fed is seeking public comment on Regulation W – Transactions Between Banks and Their Affiliates. Comments are to be submitted by August 15, 2001.

The proposed regulation represents a comprehensive review of all aspects of transactions with affiliates. It is highly recommended that banks review the proposal and provide comments to the Fed, particularly in instances where the Fed appears to apply a more restrictive reading of Sections 23A and 23B than is customary in the banking industry.