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MEMORANDUM

November 1, 2002

To Our Clients and Friends

Re: Federal Reserve's Regulation on Section 23A and 23B

The Federal Reserve Board (the "Board") has issued a final regulation ("Regulation W") relating to Section 23A and Section 23B of the Federal Reserve Act, which relate to transactions with affiliates. In addition, the Board has requested public comment on a proposed rule to limit the application of its long-standing interpretation that permits banks to purchase assets from affiliates under an exception known as "Section 250.250."

The Board's rule becomes effective April 1, 2003. Comments on the proposed rule to limit Section 250.250 are due in early December 2002.

SECTIONS 23A AND 23B

Sections 23A and 23B apply limitations on extensions of credit and certain other types of transactions ("covered transactions") between banks and their affiliates.¹ Over the years, the Board had issued numerous interpretations and rulings that construed the statutory provisions. With the enactment of the Gramm-Leach-Bliley Act ("GLB Act"), the Board concluded that a regulation that incorporated the numerous interpretations that the Board and staff had issued was desirable. Accordingly, it has adopted Regulation W to address issues relating to Sections 23A and 23B.

¹ Generally, Section 23A prohibits a bank from engaging in a covered transaction with affiliates in an amount that exceeds 10 per cent of the bank's capital for each affiliate and 20 per cent for all affiliates. In addition, collateral in varying amounts depending upon type must be posted to secure certain covered transactions. Section 23B generally requires that covered transactions and certain other transactions between a bank and its affiliates be on market terms and conditions.

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DERIVATIVE TRANSACTIONS AND INTRADAY CREDIT

The Board included the following additional provisions in the final regulation relating to derivative transactions and intraday credit:

- Derivative transactions between banks and their affiliates will be subject to Section 23B.
 - Such transactions will be required to be on market terms and conditions; and
 - Banks will be required to adopt policies and procedures to manage credit exposures arising from such transactions.
- Credit derivative transactions in which the bank protects a nonaffiliated from credit exposure from the bank's affiliate will be subject to Section 23A.
- Intraday extensions of credit will not be subject to Section 23A, but will be subject to Section 23B, and accordingly, will be required to be on market terms and conditions.
 - Banks will be required to adopt policies and procedures to manage credit exposure from intraday credit extended to affiliates.

FINANCIAL SUBSIDIARIES

- Generally, transactions between a bank and its subsidiaries are not subject to Sections 23A and 23B.
- However, the Board determined that transactions between a bank and its financial subsidiaries will be subject to Sections 23A and 23B.
- A financial subsidiary is a bank subsidiary that engages in an activity that is not permissible for national banks to conduct directly.
 - Insurance agency subsidiaries will not be treated as financial subsidiaries because they require little funding from the bank and do not represent a substantial threat to bank safety and soundness.
 - Subsidiaries of state banks that engage only in activities permissible for a state bank to conduct directly will also be exempt from the regulation.
 - Financial subsidiaries of thrift institutions will not be subject to the regulation.

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GENERAL PURPOSE CREDIT CARDS

- A credit card used to purchase products from an affiliate of the bank that issued the card is subject to Section 23A because the proceeds of the loan to the cardholder are paid to the affiliate.
- In order to avoid hardship to credit card issuers, the regulation will exempt general purpose credit cards from Section 23A if less than 25 per cent of the aggregate amount of purchases with the card are from an affiliate of the bank.
- Extensions of credit in connection with special purpose credit cards that can be used only at an affiliate of the bank will remain subject to Section 23A.

VALUATION OF INVESTMENTS AND ACQUISITIONS

Section 23A covers a bank's purchase of or investment in securities of an affiliate. Historically, the Fed staff has advised banks to regard the purchase price of an affiliate's securities as the value of the securities for purposes of Section 23A. However, the Board has changed this approach, and will require banks to value the purchase of or investment in securities of an affiliate at the greater of the bank's purchase price or carrying value. Therefore, any increase in the bank's carrying value of the securities will increase the amount subject to Section 23A. This provision will not apply to securities of a financial subsidiary, which are subject to special rules under the GLB Act.

The regulation also subjects affiliate securities to Section 23A if they are contributed to the bank for no consideration and the affiliate becomes an operating subsidiary of the bank. The value of such securities will be determined by the amount of liabilities possessed by the affiliate.

FOREIGN BANKS

Although Sections 23A and 23B do not apply to U.S. branches and agencies of foreign banks, for competitive reasons the Board has determined to apply them to transactions between a U.S. branch or agency of a foreign bank and an affiliate if the affiliate is engaged in the U.S. in any of the following activities:

- Non-credit related insurance underwriting
- Full-scope securities underwriting and dealing
- Merchant banking
- Insurance investment activities

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- Transactions with a portfolio company controlled by a foreign bank under merchant banking or insurance company investment authorities

The parent bank's capital would be used to determine the applicable Section 23A limits.

SECTION 250.250

Section 250.250 exempts a bank's purchase of a loan from an affiliate from Section 23A if the bank makes an independent evaluation of the borrower's creditworthiness and the bank commits to purchase the loan before the affiliate commits to make the loan. The Board staff had previously limited banks to purchasing no more than 50 per cent of the loans made by the affiliate. This limitation has been incorporated into the regulation.

In addition, the Board is proposing to limit the amount of assets that may be purchased from an affiliate under the Section 250.250 exception to an amount equal to 100 per cent of the bank's capital.

INTERNAL REORGANIZATIONS

The Board has granted, on a case-by-case basis, exceptions to Section 23A in connection with internal reorganizations involving the transfer of assets from an affiliate to the bank. The regulation has adopted an exception to Section 23A for internal corporate reorganizations if:

- The holding company informs the Board of the transaction
- The company commits to make the bank whole if any transferred assets become low-quality assets within two years
- A majority of the bank's directors approves the transaction
- The value of the transaction is less than 10 per cent of the bank's capital (or up to 25 per cent if the bank's federal supervisor approves)
- The bank holding company and all its subsidiary banks are well capitalized and well managed

LOANS SECURED BY MUTUAL FUND SHARES

Section 23A applies to a bank's acceptance of securities issued by an affiliate as collateral for a loan to a customer. The Board has adopted an exception to this general rule in connection with loans secured by affiliate-issued mutual fund shares under the following conditions:

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- The mutual fund is an open-end investment company registered with the SEC under the Investment Company Act of 1940
- The mutual fund shares serving as collateral has a publicly available market price
- The bank and its affiliates do not own more than 5 per cent of the fund's shares
- The proceeds of the loan will not be used to purchase shares that serve as collateral or otherwise benefit an affiliate

Regulation W and the proposed rule can be found at
<http://www.schwartzandballen.com/WhatsNew.htm>.

If you have any questions concerning the regulation or the proposed rule, please call Gilbert Schwartz, Robert Ballen or Tom Fox at (202) 776-0700.