FS Regulatory Brief

23A revisited – significant changes to affiliate transaction rules are coming

Overview

Section 608 of the Dodd-Frank Act marks the meeting of two complex banking laws – the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank or the Act) and Section 23A of the Federal Reserve Act (and its implementing Regulation W) which limits bank transactions with affiliates.

Section 608 makes a number of significant changes in Section 23A which are intended to expand coverage, e.g., to include derivative transactions, and generally tighten certain aspects of the law, such as how collateral requirements are determined.

The changes become effective in less than two months – on July 21, 2012 – and to date there has been no guidance of what the Federal Reserve Board ("the Board") will be doing to interpret and implement the changes in Regulation W. Informally, the Board's staff has indicated that it is working feverishly on a regulatory proposal which it intends to release just before July 21st.

This PwC FS Regulatory Brief is intended to serve as a summary of the changes made by Dodd-Frank to bank affiliate transaction rules, the status of regulatory efforts, what banks can be doing now to assess possible impacts, and some significant open issues from our perspective.

Section 608 of the Dodd-Frank Act makes significant changes to bank affiliate transaction rules

Among the more significant bank regulatory provisions of the Act is Section 608, which expands the scope of bank transactions with affiliates subject to the limits and requirements of Section 23A of the Federal Reserve Act and the Board's Regulation W.

The changes made to Section 23A are to be effective on July 21, 2012, yet no informal or formal guidance on these changes has been provided by the Board on how these changes will be interpreted and applied. The most impactful changes are dependent on how the Board will interpret and apply new provisions that, for example, will include within the limits and collateral requirements of Section 23A the extent to which a bank's derivative transaction with an affiliate causes the bank to have a "credit exposure" to an affiliate.

We understand that the Board's staff is working diligently on drafting a proposed rule to implement the changes that would be published before July 21, 2012, with some guidance about how to value derivatives and securities lending transactions, "perhaps" with a transition period. Should that prove too difficult as a matter of timing, the Board may consider the need to provide some separate guidance (perhaps with a transition period).

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Section 23A of the Federal Reserve Act – which institutions are impacted?

Section 23A of the Federal Reserve Act is a key prudential requirement that imposes quantitative limits, qualitative standards and collateral requirements on certain transactions by a national bank or State member bank with its affiliates that are intended to limit and collateralize a bank's credit exposure to any affiliate and to all affiliates in the aggregate.

The Board has implemented Section 23A and its companion Section 23B in the Board's Regulation W.

- Section 23B requires that member bank transactions with affiliates be on prevailing market terms and conditions for comparable third-party transactions or, in the absence of comparable transactions, on market terms and conditions that would be offered in good faith to a third-party.
- State nonmember banks and Federal and state thrifts must also comply with Regulation W under respective regulations of the Federal Deposit Insurance Corporation ("FDIC") and Office of the Comptroller of the Currency ("OCC").
- In addition, Regulation W extends the requirements of Sections 23A and 23B to transactions between a US branch or agency of a foreign bank and any of its US Financial Holding Company affiliates (main impact is on transactions with US broker-dealer affiliates).

All of the preceding banking organizations covered by Regulation W will be collectively referred to herein as "banks."

Section 608 of the Dodd-Frank Act – changes to definitions

A covered affiliate

Section 608 of the Act makes a number of different changes to Section 23A with the general intent being to expand the statute's reach and to amplify its impact. A key change to the definition of an affiliate will expand coverage of funds advised by a bank or its affiliates.

Definition of affiliate. The Act expands the definition of "affiliate" for purposes of Section 23A to include any "investment fund" for which a bank or its affiliates is an "investment adviser." This is broader than current law and Regulation W, most notably with respect to hedge and private equity funds which are only defined as an affiliate under Regulation W if advised by a bank or its affiliates which, in the aggregate, also own 5% or more of any class of voting securities or of the equity capital of the fund. The amendment effectively eliminates any ownership requirement by a bank or its subsidiary: serving as an investment adviser will be sufficient to make an investment fund an affiliate.

A covered transaction

A "covered transaction" between a bank and its affiliate is subject to Section 23A and Regulation W. The Act expands this definition to include derivative transactions and securities lending and borrowing transactions between a bank or its subsidiary and any affiliate "to the extent" that the transaction "causes "a bank or a subsidiary to have "credit exposure" to the affiliate. The term "credit exposure" is not defined in the Act.

Derivative transactions. Under Regulation W, derivative transactions between a bank and its affiliates are subject to Section 23B. While certain credit derivatives in which a bank provides credit protection to a third-party dealing with an affiliate are subject to Section 23A, banks are generally required to have policies and procedures to manage "credit exposure" from derivatives transactions with affiliates. Section 608 – by treating such credit exposure as a covered transaction – is thus a fundamental change from the risk management approach of Regulation W to derivative transactions with affiliates and will likely limit and increase the costs of such transactions.

Securities lending and borrowing transactions. The Board has issued a number of letter rulings granting full or limited exemptions from Section 23A for specific bank securities lending and borrowing programs involving affiliates that had some credit exposure but were not deemed to pose substantial risk. The amendment effectively codifies the coverage of such programs under Section 23A to the extent credit exposure is involved but requires conformance with the exposure limits and collateral requirements of Section 23A. As with derivatives coverage, this change will limit and likely increase the costs of such transactions.

Acceptance of affiliate debt securities as loan collateral. Under current rules, a covered transaction includes the acceptance of affiliate "securities" by a bank or its subsidiary as collateral for a loan to a third party. The Act expands that to include acceptance of "other debt obligations" issued by an affiliate as collateral.

Elimination of certain exemptions for a financial subsidiary. Section 608 eliminates two exceptions that had been provided for transactions between a national or state bank and a "financial subsidiary" authorized to engage in expand financial activities under the Gramm-Leach-Bliley Act. The result is that bank transactions with any single financial subsidiary will be subject to the 10% capital limit on transactions with any one affiliate and earnings retained in a financial subsidiary will be counted toward the investment limit.

Collateral requirements

Collateral requirements apply under Section 23A to each loan, extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of an affiliate by a bank or its subsidiary. Section 608 expands the application of collateral requirements and requires collateral coverage be maintained at all times.

Derivatives and securities lending and borrowing. The Act amends Section 23A so that any credit exposure caused by derivatives or securities financing transactions with affiliates will also be subject to the collateral requirements.

Repurchase transactions. The Act also amends Section 23A to treat a purchase of assets subject to an agreement to repurchase from an affiliate as an extension of credit subject to collateral requirements. Under current rules, a repo is a covered transaction subject to the quantitative limits but is not required to be collateralized.

Determining collateral coverage. The Act requires that a bank or its subsidiary's credit exposure to its affiliates be secured "at all times" by required collateral amounts. Under current rules, the collateral requirement is determined "at the time of the transaction" and additional collateral is only required to replace retired or amortized collateral in amounts necessary to maintain the secured coverage equal to the minimum required at the inception of the transaction.

Impact of netting agreements

Section 608 allows the Board to consider the impact of netting agreements in determining the amount of a covered transaction and collateral coverage.

The Act provides the Board with specific authority to issue such regulations or interpretations as may be necessary or appropriate to take into account the manner in which a netting agreement between a bank or its subsidiary and an affiliate may be considered in determining the amount of a covered transaction, including the extent to which a covered transaction is fully secured.

Exemptions from Section 23A or 23B will now be a multi-agency matter

The amendments made by section 608 provide a greater role for the FDIC and OCC in the granting of exemptions from Sections 23A or 23B.

Currently, the Board at its discretion may exempt transactions from Section 23A by regulation or order.

Under Section 23A as amended, the Board's ability to provide exemptions by order or rule-making can be effectively vetoed by the FDIC if within a 60-day window, the FDIC objects to the exemptions as providing an unacceptable risk to the Deposit Insurance Fund.

The amendments further provide that national banks may by order of the OCC be granted an exemption from Section 23A if the Board and OCC agree that it is in the public interest and the FDIC does not object. The FDIC and Board can exempt transactions by state member banks and state nonmember banks, respectively, if they jointly agree the exemption is in the public interest and the FDIC does not object on the basis of an unacceptable risk to the Deposit Insurance fund. Similar changes are made to the rules governing exemptions from 23B.

Any interpretation of the treatment of netting agreements for a specific bank will have to be jointly issued by the Board and the applicable agency – the FDIC or OCC.

Initial vulnerability analysis

To the extent it has not already done so, a bank would benefit from doing an initial analysis of its vulnerability to the changes made to current rules.

Each bank is expected under Regulation W to maintain a current list of affiliates. A bank thus needs to determine whether the change to the definition of affiliate will require the addition to its affiliate list under Regulation W, especially of hedge funds or private equity funds not previously covered because of the threshold ownership requirement.

A bank will need to inventory those derivatives, securities financing or other transactions with affiliates that will be newly treated as covered transactions under the Act, and assess the possible impacts on the amount and costs of such transactions, and what exemptions may be applicable under Regulation W (for example, the exemption for transactions secured by cash or US Government obligations is made applicable to derivatives and securities lending and borrowing transactions). A bank will also want to consider potential alternative financing mechanisms and what monitoring and reporting framework enhancements may be required.

A bank will need to assess the sources, availability and cost of collateral to cover derivatives, securities financing and repo credit exposure and assess how best to monitor the market value of collateral on a daily basis to ensure all covered extensions of credit or credit exposures to any affiliate and all affiliates are fully secured at all times.

A bank will need to review the extent to which derivatives and other covered transactions with affiliates are covered by netting agreements and how such agreements may reduce credit exposure or extensions of credit to affiliates for purposes of determining the amount of such covered transactions or the availability of collateral to meet collateral requirements.

Some significant open regulatory issues

Will the Board provide a transition period to the new requirements?

There is no transition (conformance) period provided in Section 608 beyond the effective date of July 21, 2012. However, under Section 23A, the Board has authority to issue implementing regulations for Section 23A. Other more specific rule-writing authority in Section 23A also confirms the Board's ability in a similar circumstance (Gramm-Leach-

Bliley authority to cover derivatives transactions) to provide a conformance period when appropriate to prevent undue hardship under new regulations. The Board has not made any determination yet with respect to this authority and it would be prudent for affected or concerned banks singly or collectively to urge the Board to provide such a period.

If the Board provides a transition period, will that encompass all or only some of the requirements?

Since all of the changes made by Section 608 impact compliance with Section 23A – violations of which can result in significant sanctions – an all-encompassing transition period would seem appropriate. Changes dependent upon the Board's definition of new terms or requirements – such as defining credit exposure for derivatives and securities financing transactions and defining eligible netting agreements – would appear to have the strongest case for a transition period.

What impact if any will the Board's SIFI proposal on single counterparty exposure limits – which includes proposed requirements for determining credit exposure for a consolidated BHC and consolidated counterparty on derivatives, securities finance and repo/reverse repo transactions?

Banking organizations that commented on the SIFI proposal generally opposed the methodologies proposed by the Board for calculating credit exposure on derivatives, securities lending and borrowing and repo/reverse repo transactions with counterparties as significantly overstating risk. Running a scenario based on the SIFI proposal may at least provide a bank with a potential worst-case analysis until further guidance is provided.

Additional information

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