

Regulation W: bank transactions with affiliates





Regulation W: Bank Transactions with Affiliates

by Gary Welsh

REGULATION W BECOMES EFFECTIVE April 1, 2003, and expands on the regulations under Section 23A of the Federal Reserve Act (the “FR Act”). One of the primary focuses of bank regulation in the United States has been Section 23A, which imposes restrictions, limitations and requirements on bank transactions with affiliates.

This has become an area of even more focus over the past year with the “post-Enron” attention on related party transactions and disclosures.

The twofold purpose of Section 23A is to limit the financial and reputational risks to a bank from transactions with affiliates and to limit the ability of a bank to transfer its Federal subsidy, i.e., cost advantage of raising funds through government-insured deposits, to affiliates. The law initially applied only to national and state member banks; however, subsequent legislation required that FDIC-insured nonmember State banks and FDIC-insured thrift institutions comply with Section 23A as if they were member banks.

Although Section 23A dates back to Depression-era banking legislation, the Federal Reserve Board (“FRB”) never issued an

implementing regulation, effectively requiring banks over the years to rely on a series of FRB interpretations and informal staff guidance. This has also been true for Section 23B of the FR Act, enacted in 1987, which complements and supplements Section 23A by covering a broader range of transactions and by generally requiring that covered bank transactions with affiliates be on an arm’s length basis at fair market value.

The FRB’s support of the Gramm-Leach-Bliley Act (“GLBA”) and the Act’s establishment of Financial Holding Companies (“FHCs”) with broader financial powers were premised, to a large extent, on the ability of bank regulators to apply and enforce affiliate transaction rules restricting bank dealings with and financial support of holding company affiliates. Sections 23A and 23B were viewed as a crucial means to protect banks from losses in transactions with new affiliates.

With Sections 23A and 23B assuming even more importance after GLBA, the FRB determined that it needed to issue a rule that would simplify the interpretation of Sections 23A and 23B and ensure their consistent application. The FRB issued proposed Regulation W as a comprehensive rule interpreting and applying Sections 23A and 23B in 2001, and the FRB received almost 120 comments on the rule, largely from depository institutions and their trade associations. The FRB approved a final version of Regulation W in 2002, which is substantially similar to the rule proposed in 2001, but which does include a number of modifications and clarifications in response to certain comments received on the rule. The new Regulation W, which was published in the Federal Register on December 12, 2002, will become effective on April 1, 2003.

In the Preamble to its final Regulation W, the FRB states that it **“expects each depository institution with affiliates that is subject to sections 23A and 23B to implement policies and procedures to ensure compliance with the final rule.”** Banks will thus need to ensure that their policies and procedures dealing with affiliate transactions are updated to reflect the new Regulation W and to ensure that new compliance responsibilities are fully understood and implemented. Although Regulation W explicitly supersedes most of the FRB’s formal interpretations, as well as most staff opinions relating to Sections 23A or 23B, a number of interpretations are retained and should also be reviewed in updating policies and procedures. Banks will also need to ensure that their Internal Audit and/or Compliance Testing programs with respect to Sections 23A and 23B are updated to include changes required by Regulation W. Compliance will be even more important in this area as the embodiment of previous staff interpretations in a regulation increases the likelihood that numerous or repeated violations in this highly technical area could result in civil money penalty or other enforcement measures. The FRB will also be modifying its FR Y-8 Report Form – “Bank Holding Company Report of Insured Depository Institutions’ Section 23A Transactions With Affiliates,” to reflect the adoption of Regulation W, which may require changes in the ways that banks collect and report information required by the FR Y-8.

FDIC-insured savings associations will also have to comply with Regulation W, with certain technical modifications, on April 1, 2003, in accordance with an interim final rule published by the Office of Thrift Supervision on December 20, 2002.

Staff of the FRB have said that “Section 23A is simple in concept, but complicated in its application.” True to form, Regulation W is a high-

ly complex regulation – the text and accompanying explanations of the Regulation cover 57 pages of the already dense Federal Register.

Within this complexity, any depository institution approaching Regulation W must seek within its text and accompanying explanations answers to five basic questions:

1. Is the proposed transaction with an “affiliate” as defined under Regulation W?
2. If the proposed transaction is with an “affiliate,” is the transaction itself a “covered transaction” under the Regulation?
3. If the proposed transaction is a “covered transaction,” what restrictions, limitations or requirements apply to the transaction under Regulation W?
4. What valuation and timing principles apply in ensuring the covered transaction complies with the applicable restrictions, limitations or requirements of Regulation W?
5. Is the covered transaction exempt, in whole or in part, from the restrictions, limitations or requirements of Regulation W?

The scope and inherent complexity of Regulation W defies a general overview, as for each definition or critical term there are usually one or more exceptions, which in turn may be conditioned on meeting additional criteria. The following summary assumes basic familiarity with Sections 23A and 23B and is intended to highlight some of the key issues or changes addressed by Regulation W and is not intended to constitute legal or other advice with respect to any particular transaction.

Covered Affiliates. The definition of “affiliate” covered by the restrictions in Section 23A has been expanded by Regulation W to include: (i) certain unregistered investment funds in which a bank or its affiliates own or control more than 5 percent of the voting shares or equity, (ii) “financial subsidiaries” of national or state banks that engage in activities the parent bank cannot engage in directly, with the exception of insurance agency activities, (iii) certain bank joint ventures with affiliates, and (iv) employee stock option plans or trusts that exist for the benefit of shareholders or employees.

Other Definitions. Other definitional changes in Regulation W affect concepts of control, covered transactions, extensions of credit, low-quality assets and U.S. government obligations,



among others. For example, the definition of covered transactions has been expanded to include: (i) bank confirmations of a letter of credit issued by an affiliate (reversing a previous staff position), (ii) cross-guarantee agreements and cross-affiliate netting arrangements, and (iii) so-called “Keepwell” agreements where a bank commits to maintain the capital levels or solvency of an affiliate. However, the FRB confirmed that a bank’s issuance of a guarantee in support of securities issued by a third party and underwritten by a securities affiliate of the bank would not be a covered transaction. The definition of a covered “extension of credit” has been expanded to include a bank’s purchase of debt securities from an affiliate and the definition of a “low quality asset” has been expanded to include assets classified under a bank or affiliate’s internal rating system, as well as by bank examiners.

Collateral. Bank extensions of credit to affiliates must generally be secured by eligible collateral under Section 23A. Regulation W would not apply collateral requirements to the unused portion of a bank line of credit to an affiliate, so long as the bank is not obligated

to advance additional funds until the affiliate has posted the amount of additional collateral required. The Regulation also defines a category of “ineligible collateral,” which cannot be used to satisfy collateral requirements, that, among other items, includes low-quality assets, intangible assets, and guarantees, letters of credit and similar instruments. A bank’s purchase of debt securities issued by an affiliate is subject to the collateral requirement, except where the debt security is purchased from a nonaffiliate in a bona fide secondary market transaction.

Valuation and Timing. Regulation W specifies fairly detailed valuation and timing principles for four (4) different types of covered bank transactions with affiliates — credit transactions, asset purchases, purchases of and investments in securities issued by an affiliate, and extensions of credit secured by affiliate securities. With respect to this last category, Regulation W provides that an extension of credit secured by shares in an affiliated mutual fund is exempt from the valuation rule for affiliate-issued securities if certain conditions are met.

Other Requirements. Section 23A and 23B issues arise when a bank directly or indirectly acquires an affiliate. Regulation W sets forth some general rules in this area and provides an exemption for “step” transactions where a bank holding company acquires an unaffiliated company and, within a short period of time, transfers the shares to the holding company’s bank subsidiary. The rule also allows a bank to apply for individual rulings or exemptions with respect to specific transactions, a common approach in the past to dealing with difficult or larger transactions.

Derivatives and Intraday Credit. Under GLBA, the FRB is required to address the treatment of derivatives transactions and intraday credit under Sections 23A and 23B.

In the case of derivatives, Regulation W makes permanent the FRB’s interim rule which provides that derivative transactions with affiliates are subject to Section 23B, but are not generally subject to Section 23A. Nonetheless, banks are required to establish and maintain policies and procedures designed to manage the credit exposure arising from a bank’s derivative transactions with affiliates. Regulation W does cover derivatives that are the functional equivalent of guarantees under Section 23A, which are defined as credit derivatives between a bank and a nonaffiliate in which the bank protects the nonaffiliate from default on or decline in value of an obligation of the affiliate.

Intraday credit extensions of credit by a bank to an affiliate are subject to Section 23B and treated as covered extensions of credit but are then exempted from the quantitative and collateral requirements of Section 23A, if the bank establishes and maintains policies and procedures for the management of intraday credit exposure and has no reason to believe the affiliate would have any difficulty repaying the credit in accordance with its terms.

Exemptions. Regulation W restricts the scope of the sister-bank exemption permitting transactions between bank affiliates of a holding company to exclude bank affiliates that are not FDIC-insured, e.g., non-insured trust companies, but expands the exemption for bank purchases of securities from a securities affiliate to include situations where the bank or its affiliate are acting exclusively in a riskless principal capacity. A new exemption for internal corporate reorganizations is included in Regulation W.

Branches and Agencies of Foreign Banks. Although branches and agencies of foreign banks are not subject to Sections 23A or 23B, the FRB, using separate authority in GLBA to restrict transactions



between branches and agencies and their U.S. affiliates, determined that, for competitive reasons, Regulation W should apply to transactions between branches and agencies of foreign banks and U.S. “financial” affiliates authorized by GLBA for FHCs, e.g., securities, insurance and merchant banking affiliates.

Transitional Rules. Transactions entered into on or after April 1, 2003, will be immediately subject to Regulation W. Transactions entered into after December 12, 2003 (the date Regulation W was officially published), but before April 1, 2003, will become subject to Regulation W on April 1, 2003. Transactions consummated on or before December 12, 2002, that would be directly impacted by the new rule will not become subject to Regulation W until July 1, 2003, unless the transaction is renewed, extended or materially altered after April 1, 2003, in which case the rule is immediately applicable. However, any purchase of assets from an affiliate that is consummated on or before December 12, 2002, will not be subject to the rule. Of immediate benefit is the FRB’s view that a bank may apply certain provisions of Regulation W that relieve regulatory burdens before the effective date of April 1, 2003, such as the exemption for step transactions.

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