FEDERAL RESERVE SYSTEM

12 CFR Part 223

[Regulation W; Docket No. R-1135]

Transactions Between Member Banks and their Affiliates

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

SUMMARY: The Board of Governors of the Federal Reserve System proposes to amend an exemption in Regulation W that permits a member bank to exclude the purchase of an extension of credit from an affiliate from the quantitative limits imposed by section 23A of the Federal Reserve Act if certain criteria are met. The proposed amendment would limit a member bank's ability to buy an extension of credit from an affiliate under the exemption to 100 percent of the capital stock and surplus of the member bank.

DATES: Submit comments on or before **[INSERT DATE 30 DAYS AFTER THE DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Comments should refer to docket number R-1135 and should be sent to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551 or mailed electronically to regs.comments@federalreserve.gov. Comments addressed to Ms. Johnson also may be delivered between 8:45 a.m. and 5:15 p.m. to the Board's mail facility in the west courtyard of the Eccles Building, located on 21st Street between Constitution Avenue and C Street, N.W. Members of the public may inspect comments in accordance with the Board's Rules Regarding the Availability of Information (12 CFR part 261) in Room MP-500 of the Martin Building on weekdays between 9:00 a.m. and 5:00 p.m.

FOR FURTHER INFORMATION CONTACT: Pamela G. Nardolilli, Senior Counsel (202/452-3289), or Mark E. Van Der Weide, Counsel (202/452-2263), Legal Division; for users of Telecommunications Device for the Deaf (TDD) only, contact 202/263-4869.

SUPPLEMENTARY INFORMATION:

Background

Section 23A is designed to protect banks from misuse in financial transactions with their affiliates. Section 23A attempts to accomplish this goal by imposing safeguards on all "covered transactions" between a bank and its affiliates; this includes limiting all covered transactions by a bank with any single affiliate to no more than 10 percent of the bank's capital stock and surplus, and limiting a bank's covered transactions with all affiliates to 20 percent of the bank's capital stock and surplus.

In 1974, the Board issued a formal interpretation that exempted from section 23A a bank's purchase, on a nonrecourse basis, of a mortgage note or participation therein from a mortgage banking affiliate, provided that the bank's commitment to purchase was (i) obtained by the affiliate within the context of each proposed loan, (ii) obtained prior to the affiliate's commitment to make each loan, and (iii) based upon the bank's independent evaluation of the creditworthiness of each mortgagor (the "Purchase Exemption").[1] Although this interpretation did not impose a strict dollar limit on the amount of an affiliate's mortgage loans that a bank could purchase under the exemption, the interpretation cautioned that the purpose of the exemption was to allow a bank to take advantage of an investment opportunity and not to provide all the working capital needed by an affiliate.

By 1995, some bank holding companies were using the Purchase Exemption extensively to fund their nonbank lending affiliates. In those cases, banks were providing all or nearly all of such affiliates' funding. In response, staff indicated in an interpretive letter that the Purchase Exemption was not available if the dollar amount of the bank's loan purchases from the affiliate represented more than 50 percent of the total dollar amount of loans originated by the affiliate. Staff reasoned that, in these circumstances, the asset purchases look less like the bank taking advantage of an investment opportunity brought to it by the affiliate and more like the bank providing an ongoing funding mechanism for the affiliate. Staff intended that this restriction would require the affiliate to have alternative funding sources and would reduce the pressure on the bank to purchase the affiliate's extensions of credit.

In 2001, the Board reviewed a proposal where a leasing company proposed to charter a bank for the primary purpose of purchasing loans or leases from the leasing company.[2] The Board was concerned that, under the proposal, the new bank's credit underwriting process could be compromised as result of the complete dependence of the bank on the affiliate for asset growth. The Board conditioned its approval of the proposal on the bank limiting its purchases of leases or loans from an affiliate to no more than 50 percent of the bank's credit portfolio.

Concurrently with the issuance of this proposed rule, the Board is adopting final Regulation W, which incorporates the Purchase Exemption at 12 CFR 223.42(k) and formally expands the exemption to cover the purchase of any of type of extension of credit from an affiliate.

The Purchase Exemption in Regulation W also retains the limitation previously imposed by staff that prevents a bank from using the Purchase Exemption to purchase more than 50 percent of the loans originated by any affiliate. When the Board proposed Regulation W, the preamble of the regulation asked for comment on whether the rule should include a quantitative condition to the Purchase Exemption based on the size of

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[1] This exemption was codified at 12 CFR 250.250 (2002).

[2] Amplicon Inc., 87 Federal Reserve Bulletin 421 (2001).

the purchasing bank.[3] The Board, however, did not propose a specific bank-based limit at that time. Eleven commenters objected to such a condition and argued that case-by-case review is a better approach to handling situations where loans purchased from an affiliate represent a large portion of a bank's assets. These commenters believed that the remaining conditions of the Purchase Exemption should suffice to prevent abuse of the bank. One commenter, on the other hand, recommended that the rule include a 50 percent limit based on the assets of the bank.

In light of the comments and the fact that the Board did not set forth a specific limit based on the bank's size in proposed Regulation W, the Board now proposes to amend Regulation W to impose a limitation on the Purchase Exemption based on the capital stock and surplus of the bank. Specifically, the Board is requesting comment on a condition that would limit the amount of extensions of credit that a bank could purchase from an affiliate under the Purchase Exemption to 100 percent of the bank's capital stock and surplus. All other restrictions imposed by the Purchase Exemption would still apply. Although those restrictions include a requirement that the bank conduct an independent credit review prior to purchasing assets under the Purchase Exemption, sections 23A and 23B were enacted in recognition that the bank might relax its independent judgment when making credit decisions involving an affiliate. The Board believes that the 100 percent limit will guard against a bank acquiring an excessive concentration of assets under the Purchase Exemption, but still will provide the bank with the flexibility to purchase assets from an affiliate, within prudential limitations, in an amount well in excess of the statute's 10 and 20 percent quantitative limits.

Regulatory Flexibility Act

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603(a)) the Board must publish an initial regulatory flexibility analysis with this proposed regulation. As discussed above, the purpose of the rule is to limit the concentration of assets held by a bank that are originated by an affiliate and to reduce pressure on the bank to make inappropriate credit decisions. The Board does not collect data on the number of institutions that take advantage of the current exemption. There are approximately 3,300 banks below $100 million in assets, but the Board does not believe that a significant number of these institutions engage in Purchase Exemption transactions because most banks of that size do not have affiliates engaged in credit-extending activities. The requirements of the proposed rule would be the same for all depository institutions regardless of their size. The Board knows of no other regulations that overlap, conflict with, or duplicate the proposed rule. The Board solicits comment on the likely impact the proposed rule would have on depository institutions, including small depository institutions. The proposed rule contains no reporting requirement.

[3] 66 FR 24186, 24199-00, May 11, 2001.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board has reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget. The proposed rule contains no new collections of information and proposes no substantive changes to existing collections of information pursuant to the Paperwork Reduction Act.

List of Subjects in 12 CFR Part 223

Banks, Banking, Affiliates, Federal Reserve System.

For the reasons stated in the preamble, the Board proposes to amend 12 CFR part 223 as set forth below:

PART 223 – TRANSACTIONS BETWEEN MEMBER BANKS AND THEIR AFFILIATES (REGULATION W)

1. The authority citation for Part 223 continues to read as follows:

Authority: 12 U.S.C. 371c(b)(1)(E), (b)(2)(A), and (f), 371c-1(e), 1828(j), and 1468(a).

2. Section 223.42 would be amended by adding a new paragraph (k)(6) to read as follows:

§ 223.42 What covered transactions are exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition?

* * * * *

(k) Purchasing an extension of credit from an affiliate. * * *

(6) The dollar amount of the extension of credit, when aggregated with the dollar amount of all other extensions of credit purchased by the member bank from affiliates under this exemption and currently owned by the member bank, does not represent more than 100 percent (or such lower percent as is imposed by the member bank's appropriate Federal banking agency) of the capital stock and surplus of the member bank.

By order of the Board of Governors of the Federal Reserve System, November 27, 2002.

(signed) Jennifer J. Johnson
Jennifer J. Johnson,
Secretary of the Board.