Banking Affiliate Regulation Under Section 23A of the Federal Reserve Act

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BANKING AFFILIATE REGULATION UNDER SECTION 23A OF THE FEDERAL RESERVE ACT

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Before committing a bank's financial resources to an affiliate, bankers must be aware of the scope of the term "affiliate" under Section 23A of the Federal Reserve Act. Section 23A places restrictions on the financial dealings between banks and their affiliate companies. The author analyzes Section 23A and the relevant regulatory and compliance issues that have recently surfaced. The author concludes that in the event of Glass-Steagall repeal, interaffiliate regulation of the financial dealings between banks and securities affiliates, as accomplished by Section 23A, would be a viable method of permitting the merger of investment and commercial banking.

The recent barrage of banking law literature has concentrated on the provisions of the Act of 1933, commonly known as the Glass-Steagall Act, which separate investment and

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Section 16, 12 U.S.C. § 24 (seventh), restricts the ability of commercial banks to engage in securities activities. This provision applies to national banks and state member banks (12 U.S.C. § 335). It specifically provides:

The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of customers, and in no case for its own account, and the association shall not underwrite any issue of securities of stock; Provided, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. . . . The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof.

Section 20, 12 U.S.C. § 377, prohibits national and member banks from affiliating with organizations that are "engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities." This provision was designed to ensure that commercial banks do not participate in the prohibited securities activities indirectly through affiliates.

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commercial banking. The central topic of inquiry has been whether the division between investment and commercial banking is necessary and practical in the current financial markets. As a result of this focus, Section 23A of the Federal Reserve Act is one provision of the Banking Act of 1933 that has escaped the attention of the commentators. Unlike Glass-Steagall Act provisions prohibiting banks from engaging in certain securities-related activities, Section 23A prescribes general quantitative and qualitative restrictions against the various financial dealings that banks may enter into with

Section 21, 12 U.S.C. § 378(a)(1), corresponds to § 16 in its prohibition against persons and organizations engaging in securities activities from accepting deposits. It specifically provides:

(1) It shall be unlawful—

(1) for any person, firm, corporation, association, business organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits.

Finally, Section 32, 12 U.S.C. § 78, prohibits any "officer, director, or employee" interlocks between national or member banks and any persons or organizations "primarily engaged" in securities activities. This provision was designed to curb possible conflicts of interest that could arise between banks and securities businesses through the interlocking relationships.


3 12 U.S.C. § 371c. Section 23A applies to all national banks and FDIC-insured state banks. It specifically provides:

(1) A member bank and its subsidiaries may engage in a covered transaction with an affiliate only if—

(A) in the case of any affiliate, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 10 per centum of the capital stock and surplus of the member bank; and

(B) in the case of all affiliates, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 20 per centum of the capital stock and surplus of the member bank.

(2) For the purpose of this section, any transaction by a member bank with any person shall be deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate.

(3) A member bank and its subsidiaries may not purchase a low-quality asset from an affiliate unless the bank or such subsidiary, pursuant to an independent credit evaluation, committed itself to purchase such asset prior to the time such asset was acquired by the affiliate.

(4) Any covered transactions and any transactions exempt . . . shall be on terms and conditions that are consistent with safe and sound banking practices.
their banking and nonbanking affiliates. These proscriptions are designed to regulate the potential conflicts of interest that may arise between these closely related entities and to prevent banks from misusing their financial resources for the benefit of these affiliates, thus preserving banking safety and soundness.

Although absent from recent banking law discussions, Section 23A has been the focus of recent proposals by Congress and banking regulators to repeal the Glass-Steagall restrictions in order to permit banks to engage in full-fledged securities activities through securities affiliates.4 It has been

4 In 1983 and 1984, Senate bills S. 1609 and S. 2851 proposed the expansion of financial services that could be offered by banks to include insurance underwriting and brokerage, real estate development, and certain securities activities, which would have required a repeal of certain Glass-Steagall Act restrictions. Both of these bills included proposals to amend the Federal Reserve Act by adding a new § 23B, which would supplement § 23A by providing further restrictions on transactions between banks and their affiliates. The purpose of this provision was to provide the Federal Reserve Board with greater flexibility in regulating any conflicts of interest between banks and their holding company affiliates that could arise from the expanded services and operations that affiliates would be able to offer as a result of such legislation. See Moratorium Legislation and Financial Institutions Deregulation: Hearings on S. 1535, S. 1609, and S. 1682 Before Senate Committee on Banking, Housing, and Urban Affairs, 98th Cong., 1st Sess. 123-127 (1983) (testimony of Donald T. Regan, Secretary of Treasury, regarding S. 1609.); S. 2851, 98th Cong., 2d Sess. (1984) Cong. Rec., S11,162, S11,166-11,167 (Sept. 13, 1984) (hereafter referred to as Moratorium Legislation).

Although these proposed bills to expand banking services into real estate, insurance, and securities activities were not passed, § 23B resurfaced in the recently enacted Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 102, 101 Stat. 552. Section 23B is premised on § 23A and essentially provides that a bank and its affiliate may engage in certain transactions only if the terms and conditions of the transaction are substantially the same as those prevailing at the time for comparable transactions with nonaffiliated companies. These transactions include: (1) any covered transaction (as defined in § 23A) with an affiliate; (2) the sale of securities or other assets to an affiliate, including those subject to an agreement to repurchase; (3) the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise; (4) any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person; and (5) any transaction or series of transactions with a third party if an affiliate had a financial interest in the third party or if an affiliate is a participant in such transaction or series of transactions.

The most recent legislative proposal to repeal the Glass-Steagall Act restrictions against the merger of commercial banking and investment banking activities is Senate bill S. 1886, The Financial Modernization Act of 1988, S. 1886, 100th Cong., 2d Sess. Pursuant to this bill, the repeal of the Glass-Steagall Act is deemed necessary to strengthen competition in the financial services industry. Thus, the bill proposes to provide for the combination of commercial banking and investment banking activities by permitting bank holding companies to engage in securities activities through securities affiliates. To assure safety and soundness within the financial institutions industry under this structure, the bill requires that these securities affiliates are to be regulated by the Securities Exchange Commission and the Federal Reserve Board. It also includes a very significant provision for interaffiliate regulation of activities between bank and securities affiliates that will include certain prohibitions against loan transactions and securities activity between the affiliates. See S. Rep. No. 305, 100th Cong., 2d Sess. 17-18 (1988).
suggested that an interaffiliate statute similar to Section 23A would be necessary to regulate the financial dealings between banks and these securities affiliates to assure that they are at arm’s length and reflect banking safety and soundness. Such regulation is deemed necessary because of a belief that a bank’s decision to make loans or extensions of credit to a securities affiliate would be compromised in its evaluation of a securities affiliate’s request for a loan; in determining whether to require adequate security for a loan to an affiliate; and in determining whether to decline a request for funds by a troubled affiliate. There is also concern that a bank’s involvement in securities underwriting and dealing would adversely affect its judgment in determining whether to make loans to corporate clients for which its securities affiliates may have underwritten a securities issue, or in providing investment advice to its bank customers or trust accounts concerning the securities that its securities affiliates may have underwritten.

Section 23A is also worthy of attention because of its practical significance to bankers. Section 23A is a statute that all bankers must be cognizant of and reckon with in virtually every financial transaction they engage in with an affiliate. Before committing a bank’s financial resources to an affiliate, the banking staff must be aware of the vast scope of the term “affiliate” under Section 23A. That is, the bank staff must be aware of which of its banking and nonbanking subsidiaries or its parent holding company subsidiaries fall within the definition of affiliate. It must also be determined whether the proposed financial transaction is a “covered transaction” under Section 23A and whether the transaction is in compliance with the quantitative and qualitative limitations pro-

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5 See Moratorium Legislation note 4 supra, at 161-162 (testimony of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System).
6 These conflicts of interest are discussed by DiLorenzo, note 2 supra, at 676-686. Professor DiLorenzo presents arguments against Glass-Steagall Act repeal and believes that these conflicts of interest have to be avoided in order to preserve public confidence in the banking system. He expresses doubts as to whether congressional legislation would be able to provide for sufficient regulation against such conflicts.
7 Id.
8 See note 25 infra for the § 23A definition of affiliate.
scribed thereunder.9 Satisfying these requirements is not a simple task because Section 23A is intricate and extremely inclusive with respect to the kinds of business relationships and financial dealings that are covered thereunder.

The Evolution of an Interaffiliate Statute

Section 23A of the Federal Reserve Act was enacted as a part of the Banking Act of 1933. The overall purpose of the Act of 1933 was to respond to a banking system that had failed with the stock crash and financial crisis of 1929 by providing a law that would ensure a "safer use of the assets of the banks, to regulate interbank control [and] to prevent the undue diversion of funds into speculative operations."10 Section 23A was designed to assist the congressional effort to effectuate this purpose by addressing the past abusive practices of banks to extend credit and to make their financial resources available to affiliates without the benefit of careful scrutiny and unbiased consideration. In its survey and inquiry into the causes of this crisis, Congress identified the need to respond not only to the immediate emergency at hand but also to provide a cure for all of the unfortunate banking practices that had gradually seeped into the nation's banking system prior to the crisis.11 Although the banking industry's obsession with stock speculation and securities investment is often referred to as the cause of the banking crisis, it is more correct to identify the overall lending and credit practices and policies of the industry as the real culprit.12 The overall condition requiring remedy was to restrict and regulate bank loans and the use of such loans.

A major focus of the legislation under the Act of 1933 was the "banking affiliate." Congress observed that the excessive participation of banks in securities investment activities and

9 See note 3 supra and note 35 infra for the § 23A quantitative and qualitative restrictions and the definition of covered transaction.
12 "Stock-exchange speculation in excess is often spoken by some as the cause and by others as an unfortunate result of the business, banking, and credit conditions which culminated in the panic of 1929. It was neither of these, but was an accompaniment or symptom of unsound credit and banking conditions themselves." Id. at 6.

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the banks' "dangerous use of the resources of bank depositors for the purpose of making speculative profits and incurring the danger of hazardous losses" had been achieved through the "perversion of the national and state banking laws"; the greatest of these dangers was found in the growth of banking affiliates.\textsuperscript{13} The banking affiliates that were the basis for such abuse were devoted to "perilous underwriting operation, stock speculations, and maintaining a market for the bank's own stock often supported largely with the resources of the parent bank."\textsuperscript{14} Although it had been suggested that the affiliate be "abolished," it was apparent to Congress that this would not be feasible in light of the difficulty of enforcement of such a prohibition and the fact that state legislation permitted the growth of affiliates in connection with state banks and trust companies.\textsuperscript{15}

Accordingly, Congress developed a body of legislation to prevent banks from engaging in unsafe lending activities with affiliates. The legislation was designed with the following objectives:

- To separate as far as possible national and member banks from affiliates of all kinds.
- To limit the amount of advances or loans that can be obtained by affiliates from the parent institutions with which they are connected.
- To install a satisfactory examination of affiliates working simultaneously with the present system of examination applicable to the parent banks.\textsuperscript{16}

Section 23A is a direct response to the objectives described above. The fundamental purposes and principles that are embodied in this provision are designed to prevent the misuse of bank resources in virtually all possible financial transactions that might occur between a bank and its affiliate, through the imposition of both quantitative and qualitative limitations on such transactions. This prototype of the "in-

\textsuperscript{13} Id. at 10
\textsuperscript{14} Id.
\textsuperscript{15} Id.
\textsuperscript{16} Id.
teraffiliate” statute accomplishes these objectives by providing for the following:

☐ The identification of various business relationships that are inherently threatening to prudent banking judgment and bank safety and soundness, such as direct and indirect controlling interlocks between banks, parent holding companies and affiliates, or other noncontrolling relationships in which a bank may have significant pecuniary interests that might adversely affect its judgment.

☐ The identification of all possible types of credit transactions in which a bank may provide significant amounts of its financial resources.

☐ The identification of adequate collateral eligible to meet security requirements for credit extensions between banks and the regulated affiliates.

☐ The identification of practical and safe ceilings on the amount of loans and credit extensions permitted between banks and the regulated affiliates.

Revisions Under the Act of 1982

Section 23A can be briefly described as restricting member banks from engaging in certain “covered transactions” (i.e., providing loans, credit, and various forms of financial support) to (1) an affiliate to the extent that the aggregate amount of the covered transaction will not exceed 10 percent of the capital stock and surplus of a member bank and (2) for all of its affiliates, covered transactions are limited to 20 percent of a member bank’s capital stock and surplus.17 As mentioned above, such transactions are generally required to be adequately secured with acceptable collateral.18 All-

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17 Note 3 supra
18 The collateral requirements of § 23A, 12 U.S.C. § 371c(c)(1), provide in pertinent part:
(1) Each loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate by a member bank or its subsidiary shall be secured at the time of the transaction by collateral having a market value equal to—
(A) 100 per centum of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit, if the collateral is composed of—
(i) obligations of the United States or its agencies;
(ii) obligations fully guaranteed by the United States or its agencies as to principal and interest;
BANKING AFFILIATE REGULATION

though Section 23A was the subject of major revision under the Banking Affiliates Act of 1982, its original purposes and intents remain intact.

The revisions under the Act of 1982 were called for by the Board of Governors of the Federal Reserve System several years prior to the 1982 amendments. In the final appeal to the Senate and House Banking Committees of Congress, Chairman Paul A. Volcker described the amendments as being desirable because of several “major shortcomings” that the Board had identified in the original provision. The first of these being the fact that the provision was “unduly restrictive,” requiring modification in a manner that would increase financial transactions between banks and their affiliates that were not threatening to bank safety. It was also noted that the original provision was poorly drafted and organized, which the Board found made industry compliance and regulatory enforcement difficult and made way for several potentially dangerous loopholes that would expose banks to undue risks.

The Board’s approach to remedy the problematic Section 23A can be described as one that identified the flaws in the provision from a functional perspective, that is, within the context of the “fundamental purposes and principles” of the provision, and was designed to provide for an amendment that would better facilitate the goals of the provision. Accordingly, the Board recognized a need to:

(iii) notes, drafts, bills of exchange or bankers acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank; or
(iv) a segregated, earmarked deposit account with the member bank;
(B) 110 per centum of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of obligations of any State or political subdivision of any State;
(C) 120 per centum of the amount of such loan or extension of credit, guarantee, acceptance, or letter of credit if the collateral is composed of other debt instruments, including receivables; or
(D) 130 per centum of the amount of such loan or extension of credit if the collateral is composed of stock, leases, or other real or personal property.

22 Id.
23 Id.
Redefine the term affiliate so that it would be less restrictive and would allow for a freer and more flexible movement of funds between banks and entities previously included under the definition of affiliate that are less likely to result in unsafe or unsound lending practices;

More clearly present the types of financial transactions that were subject to Section 23A restrictions and to expand the covered transactions to provide banks with greater protection against undue risks providing funds to affiliates in financial transactions that had previously slipped through the originally listed prohibited transactions;

Expand the existing quantitative limitations to include banking subsidiaries that were not included within the definition of affiliates to eliminate a loophole of allowing banks to use subsidiaries that were not included in the definition of affiliate as conduits to transfer unlimited funds to affiliates; and

Expand the list of the property and assets that may be used as collateral to secure financial transactions between banks and their affiliates, to prohibit a bank from accepting an affiliate’s stock or debt obligation as eligible collateral for loans or extensions of credit made to or for the benefit of the affiliate, and to require that retired or amortized assets be replaced to satisfy collateral requirements.24

A discussion of these amendments and the ills that they were designed to remedy provides the greatest opportunity to understand the objectives of Section 23A and the fundamental purposes and principles outlined here.

Redefinition of “Affiliate”

The first and most expansive amendments to Section 23A were made to the definition of affiliate. Entities that are subject to regulation under Section 23A and are thus included

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24 A Discussion of Amendments to Section 23A of the Federal Reserve Act Proposed by the Board of Governors of the Federal Reserve System, (Sept. 1981) (hereafter referred to as Discussion of Amendments to Section 23A). The following description in the text of the 1982 amendments is based on this proposal, which was forwarded by Chairman Volcker to Congress.
within the definition of affiliate are those that are so closely related or connected to the member bank that transactions between the bank and the affiliate would not be at arm's length.25 These relationships present concern that banks will not exercise prudent judgment and scrutiny in determining whether to provide the affiliate with loans or credit, which could adversely affect the banks' financial resources and put those resources in jeopardy. The original definition of the term affiliate was more broadly written so as to include the parent holding company of a member bank, other subsidiaries of the holding company, and any company interlocked with the member bank directly through shareholders or directors or indirectly through a trustee relationship. Under this definition, sister banks within a holding company system qualify as affiliates.

Exemption of Sister Banks

The Board found that the restrictions of Section 23A were not necessary to regulate the financial transactions between

25 The term affiliate is defined under § 23A, 12 U.S.C. § 371c(b)(1), as follows:

(A) any company that controls the member bank and any other company that is controlled by the company that controls the member bank;
(B) a bank subsidiary of the member bank;
(C) any company—
   (i) that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly by trust or otherwise, the member bank or any company that controls the member bank;
   (ii) in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the member bank;
(D)(i) any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the member bank; or
   (ii) any investment company with respect to which a member bank or any affiliate thereof is an investment advisor as defined in section 2(a)(20) of the Investment Company Act of 1940; and
(E) any company that the Board determines by regulation or order to have a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship to the detriment of the member bank or its subsidiary.

Section 23A provides in pertinent part:

[A] company or shareholder shall be deemed to have control over another company if (i) such company or shareholder, directly or indirectly, acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the other company; (ii) such company or shareholder controls in any manner the election of a majority of the directors or trustees of the other company; or (iii) the Board determines, after notice and opportunity for hearing, that such company or shareholder, directly or indirectly, exercised a controlling influence of the management or policies of the other company.

sister banks within a holding company system and that the concerns of imprudent influence resulting from affiliated relationships were not an issue for concern because majority-owned sister banks are more like branches of one another and should be viewed as entities that are one and the same. Perhaps, the most compelling reason for the exemption of sister banks from the restrictions of Section 23A is the fact that both entities are subject to the same type of regulatory and examination processes and often are regulated by the same federal and state banking agencies. Accordingly, the threat of unsafe banking practices occurring is less likely where the regulatory oversight of the bank and the affiliate is the same.

Some operational advantages also result from the exemption of sister banks from the restrictions of Section 23A. One advantage is in the increased flexibility in the transfer of funds within a holding company system, allowing affiliates to take advantage of intermarket yield differentials. Member banks are also more able to rescue a financially troubled sister bank within a holding company system. However, to protect a member bank from the risk of falling into an unsafe condition by permitting unrestricted loan and credit transactions with sister banks, member banks are now prevented from acquiring any “low-quality assets” from a sister bank that could jeopardize the condition of the bank.

26 Discussion of Amendments to Section 23A, note 24 supra, at 10-11.
27 Id. at 11.
28 In its discussion of the advantages and disadvantages of permitting unlimited financial transactions between sister banks under § 23A, the Board stated:

By allowing unlimited transactions, one or more banks in a holding company system could go to the rescue of a financially troubled sister bank. Such aid (through loans, asset purchases, etc.) might save the troubled bank from failure without seriously damaging the other bank(s).

The advantages associated with allowing unlimited transactions between sister banks, however, are countered by several disadvantages. First, a large-scale rescue operation, as described above, might backfire and spread one bank’s financial troubles throughout the holding company system and eventually result in multiple bank failures. Second, allowing unlimited transactions would open the door to a large-scale transfer of low-quality assets from one bank to another in an effort to avoid criticism and the effectiveness of the bank examination process in uncovering problem bank situations. Finally, a problem could arise in those situations where a holding company does not own all of the shares of one of the banks that it controls. In such cases, a holding company could benefit from encouraging transactions between a wholly-owned bank subsidiary and a less-than-wholly-owned bank subsidiary on terms that are adverse to the latter.
Nonbank Subsidiaries of Member Banks

In addition to the exemption of majority-owned sister banks from the restrictions of Section 23A, certain majority- and minority-owned nonbank subsidiaries of member banks are also excluded from these restrictions. These subsidiaries, which typically exist solely to provide operational services for the banks, are also subject to some banking agency supervision and regulation and are generally viewed as departments within a bank. As with sister banks, structural safeguards are embodied in these relationships to assure safe and sound banking practices and do not require the proscriptions of Section 23A. 29

The Board also identified relationships between banks and entities previously excluded from the restrictions of Section 23A that needed to be subject to some Section 23A oversight.

The Board believes that the best regulatory approach to transactions between a bank and its sister banks under Section 23A is (1) to define each sister bank as an affiliate, and (2) to exempt all transactions with a sister bank (other than the purchase of low-quality assets, and transactions which the Board believes should be prohibited) if the same holding company owns or controls, directly or indirectly, 80 percent or more of the voting shares of both banks. This proposed treatment offers the principal advantages associated with unlimited transactions among sister bank subsidiaries and, at the same time, minimizes any associated disadvantages. Allocative efficiency would be promoted by this approach as a holding company would be allowed significant freedom to transfer funds among its subsidiary banks. At the same time, a holding company would be prevented from forcing one of its banks to buy low-quality assets from another bank subsidiary, thereby possibly causing the failure of a previously sound bank. In addition, the passing of low-quality assets between sister banks in an attempt to stay one step ahead of the bank examiners would not be permitted. Finally, this proposal would offer minority shareholders protection from abuse in those cases where the holding company owns or controls less than 80 percent of the shares of either bank in the transaction (emphasis added) (footnotes omitted).


29 These nonbank subsidiaries are exempt from the definition of affiliate under paragraph (b)(2) of § 23A, 12 U.S.C. § 371c(b)(2), which provides:

[T]he following shall not be considered to be an affiliate:
(A) any company, other than a bank, that is a subsidiary of a member bank, unless a determination is made under paragraph (1)(E) not to exclude such subsidiary company from the definition of affiliate;
(B) any company engaged solely in holding the premises of the member bank;
(C) any company engaged solely in conducting a safe deposit business;
(D) any company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and
(E) any company where control results from the exercise of rights arising out of a bona fide debt previously contracted, for the period of time specifically authorized under applicable State or Federal law or regulation or, in the absence of such law or regulation, for a period of two years from the date of the exercise of such rights.
because they presented concern that financial transactions between these entities were not always at arm's length. Entities that were originally excluded from the definition of affiliates included minority-owned subsidiaries of member banks and companies that only had shareholder or director interlocks with the parent bank holding company of a member bank. Minority-owned subsidiaries of a member bank were not included within the definition of affiliate because the possibility of undue pressure or coercion in influencing a bank’s decisions to enter into financial transactions with these entities was less likely because of an insignificant amount of common control or ownership.

Transactions With a Joint Venture

Unfortunately, this theory proved not to be the case with respect to foreign joint ventures and investments in which member banks did not have a controlling interest as defined under Section 23A. The Board concluded that many financial transactions that occurred between such foreign joint ventures and investments did not involve the kinds of credit risk assessments and fund disbursement procedures that member banks conduct in arm’s-length transactions. The potential for impartiality in transactions with foreign investment hinges largely on the banks’ desire to enhance their competitive positions in foreign markets and their ability to attract these more lucrative investment opportunities. Because all minority-owned subsidiaries do not present the same threat of

30 The Board’s assessment of the various “practical difficulties” that would occur if transactions between banks and foreign joint ventures were subject to § 23A was as follows:

First, and perhaps most important, such restrictions could serve to nullify present informal commitments by U.S. banks to their foreign joint ventures. . . . The Board questions whether such provisions could be suitably written to deal with all other types of informal bank commitments to existing joint ventures. The concern is that such provisions would not take into consideration cases in which no formal agreement exists but in which foreign government authorities and foreign suppliers of funds have relied on the informal implicit guarantee of the joint venture partners. . . . Second, the application of Section 23A’s restrictions to transactions between a U.S. bank and its foreign joint venture would likely make it more difficult for U.S. banks to find joint venture partners abroad, since U.S. banks would no longer be able to make the informal (or formal) commitments referred to above.

Discussion of Amendments to Section 23A, note 24 supra, at 16-17

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non-arm's-length transactions, the exclusion of minority-owned subsidiaries from the definition of affiliate continues. Nevertheless, the restrictions of Section 23A may be applied to minority-owned subsidiaries like foreign joint ventures and investments as deemed appropriate by the Board. It is important to note that one of the criticisms of this amendment is that it places the determination of Section 23A application in such cases in the hands of regulators, who must make very difficult "judgmental ad hoc decisions." Thus, bankers are faced with an element of uncertainty in their decisions to engage in any covered transaction with a joint venture.

Interlocks

As indicated above, the original definition of affiliate included companies with interlocking relationships with member banks. The Board recommended that this definition be expanded to include the interlocks of parent bank holding companies, noting that the same potential abuses and impartiality in financial transactions between a member bank and companies with which it might have direct interlocks could also occur in transactions between the member bank and the interlocks of its parent holding company. This expansion has a great impact on banking systems that are set up as "chain one" bank holding companies. Now, the banks in a chain of banks of one bank holding company are considered affiliates of one another.

31 The Board noted that the inclusion of minority-owned nonbank subsidiaries would also contradict the purposes of § 23A:

[T]o define all minority-owned companies as affiliates would violate the principle of restricting only transactions between banks and companies with which the bank has a "non-arm's-length" relationship. Since there is some small critical ownership percentage below which the relationship may be deemed to be at "arm's-length," transactions with companies of which the bank owns less than the critical percentage of shares need not be restricted.

Id. at 17.

32 Pursuant to paragraph (b)(1)(E) of § 23A, 12 U.S.C. § 371c(b)(1)(E), the Board may exercise this authority:

[T]he term "affiliate" with respect to a member bank means—(E) any company that the Board determines by regulation or order to have a relationship with the member bank or any subsidiary or Affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship to the detriment of the member bank or its subsidiary.
Another significant addition to the definition of affiliate was the inclusion of bank-advised real estate investment trusts (REITs) and other organizations that are sponsored and advised by a bank or its affiliate. The reasons for the inclusion of these entities is reflective of the principles and purposes of Section 23A. It was argued that the nature of the relationship between banks and REITs justified this inclusion:

[T]here is usually a contract between some entity in the banking organization and the REIT whereby the entity advises the REIT with respect to investments and investment policy and administers the day-to-day operations of the REIT, subject to the supervision of the trustees. Second, the banking organization generally selects the initial trustees, of which one or several, but less than a majority, are usually associated with the banking organization. Furthermore, continued representation by the banking organization among the trustees is common. Third, the REIT generally has a name similar to that of its sponsoring banking organization. The result of these ties is generally a "non-arm's-length relationship between the bank and the advised REIT."3

The Scope of "Covered Transactions"

The second major change made in Section 23A was to identify the covered transactions more clearly in order to enhance the compliance efforts of the industry. There were also some significant substantive changes made in the definition of covered transaction as well. As originally enacted, the term covered transaction included the following financial transactions:

- Loans or extensions of credit to an affiliate such as purchases of securities or other assets or obligations under a repurchase agreement; the discount of promissory notes, bills of exchange, conditional sales contracts or similar paper; loans or extensions of credit to a director, officer, employee, or other representative of any affiliate to the extent that the proceeds thereof are used for the benefit of or transferred to the affiliate;

33 Discussion of Amendments to Section 23A, note 24 supra, at 23 n.2.
Investments in the capital stock, bonds, debentures, or other obligations of affiliates; and

The acceptance of capital stock, bonds, debentures, or other obligations of an affiliate as collateral to secure loans to any person, partnership, association, or corporation.\textsuperscript{34}

The amendments to Section 23A expand the types of covered transactions to include other major transactions in which a bank may commit its financial resources to serve the credit needs of an affiliate:

- Loans or extensions of credit;
- All assets purchased from an affiliate, including assets subject to agreement to repurchase;
- The issuance of guarantees, acceptances, and letters of credit by member banks on behalf of affiliates;
- A purchase of or investment in the securities issued by an affiliate; and
- The acceptance of an affiliate's securities as collateral for a loan or extension of credit to any person or company.\textsuperscript{35}

As noted, member banks are also \textit{absolutely} prohibited from acquiring any low-quality assets from an affiliate.\textsuperscript{36} However, the Board recommended that banks should be al-

\textsuperscript{35} 12 U.S.C. § 371c(b)(7) specifically provides that the term covered transaction includes:

(A) a loan or extension of credit to the affiliate;
(B) a purchase of or an investment in securities issued by the affiliate;
(C) a purchase of assets, including assets subject to an agreement to repurchase, from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation;
(D) the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit to any person or company; or
(E) the issuance of a guarantee, acceptance, or letter of credit, on behalf of an affiliate.

\textsuperscript{36} The term low-quality asset means an asset that falls in any one or more of the following categories:

(A) an asset classified as "substandard," "doubtful," or "loss" or treated as "other loans especially mentioned" in the most recent report of examination or inspection of an affiliate prepared by either a Federal or State supervisory agency;
(B) an asset in a nonaccrual status;
(C) an asset on which principal or interest payments are more than thirty days past due;
or
(D) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.

lowed to purchase "within limit non-low-quality assets from an affiliate so long as that asset has a readily identifiable and publicly available market value or quotation and is purchased by the bank at that market value." Because these assets are purchased at market value, the purchase would not expose the banks to undue risks.

Expanding Quantitative Limitations

The third major change in Section 23A expanded the quantitative restrictions to apply to covered transactions between affiliates of member banks and nonaffiliate subsidiaries of member banks. The reason for this expansion is to eliminate the possibility of banks using their nonaffiliate subsidiaries as conduits to transfer unlimited funds to their affiliates. Accordingly, covered transactions between a bank’s nonaffiliate subsidiary and an affiliate may not exceed 10 percent of the bank’s capital stock and surplus, and covered transactions between a bank’s nonaffiliate subsidiary and all affiliates may not exceed 20 percent of the bank’s capital stock and surplus.38

Collateral Requirements

The final major change to Section 23A involved the collateral requirements. Under the original provision, bank loans and extensions of credit to an affiliate had to be secured by collateral such as stocks, bonds, debentures, or other obligations or paper eligible for rediscount or purchase by Federal Reserve banks. The market value of this collateral had to equal 100 percent of the loan amount if the collateral was a U.S. obligation, or 110 percent of the loan amount if it was an obligation of a state or political subdivision, or 120 percent of the loan amount for any other obligation.39 The amendments

37 Discussion of Amendments to Section 23A, note 24 supra, at 34. This exception in § 23A specifically provides: "The provisions of this section [23A], . . . shall not be applicable to . . . purchasing assets having a readily identifiable and publicly available market quotation and purchased at that market quotation or purchasing loans on a non-recourse basis from affiliated banks." 12 U.S.C. § 371c(d)(6).
38 See note 3 supra.
to Section 23A expand the list of eligible collateral to include "stock, leases or other real estate or personal property." This was deemed necessary because the limited group of eligible collateral under the original provision was so restrictive that many affiliates did not possess enough of the required collateral to secure their obligations with banks, thus the ability of banks to make such loans to their affiliates was limited.  

As with the original provision, the amendments increasing the eligible collateral are based on the relationship between the market value of the collateral and the loan amount. The amendments also prohibit the use of the securities of an affiliate as collateral for loans or credit extensions by banks made to or for the benefit of its affiliates. The concern being that in the event of a default on a loan or credit obligation by an affiliate, the securities of the affiliate would also decline in value, leaving the bank undersecured.

Regulatory Objectives

By analyzing Section 23A as the prototypical statute regulating interaffiliate transactions, certain guidelines can be developed for application when forming similar interaffiliate statutes such as one that might accompany the legislative expansion of banking activity into full-fledged securities activities. As already noted, the essence of such a statute is in the clear expression of the qualitative and quantitative proscriptions thereunder. A precise identification of the entities and/or relationships that are to be the subject of the regulation is very important.

The first objective of this kind of statute is to regulate transactions between a bank and an entity that the bank is so closely related to, or has interest in, such that the bank’s judgment might be biased to the extent that it is detrimental to

\[40\] 12 U.S.C. § 371c(c)(1); see note 18 supra.

\[41\] "The securities issued by an affiliate of the member bank shall not be acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, that affiliate or any other affiliate of the member bank." 12 U.S.C. § 371c(c)(4).
the financial stability of the bank and the interest of its depositors and customers. The typical non-arm’s-length relationship usually involves direct interlocking shareholder or director control between the bank and the affiliate. Indirect control relationships between the bank and the securities affiliates of a parent holding company should also be included in the list of affiliated relationships because of the influence that the parent holding company may exert over the bank’s decision to extend financing to the parent’s subsidiary. Accordingly, wholly owned or majority-owned securities affiliates of a bank or a bank’s parent holding company would be typical subjects of interaffiliate regulation because of the influence and conflict of control between the entities.

Factors other than common control between the bank and the securities affiliate will also have to be considered in determining whether the dealings between a bank and a securities entity would not be at arm’s length. For example, the existence of a significant advisory relationship between a bank and a securities affiliate that it does not have a controlling interest in would warrant regulatory oversight, as would attractive and advantageous market expansion opportunities or preexisting investment obligations or commitments between the bank and the minority-owned securities affiliate. Whether these noncontrolling affiliations are to be specifically included within the list of regulated relationships depends on the likelihood of banking prudence failing in dealings between the entities. A provision allowing for independent agency determinations on whether noncontrolling relationships between banks and securities entities should be subject to interaffiliate regulation may be sufficient to cover these special cases.

The second objective of this regulation is to identify all of the kinds of transactions that may occur between a bank and an affiliate in which the bank’s financial resources may be used to benefit the affiliate. In conjunction with this objective, the statute should proscribe practical and safe limits on the amount of funds that the bank can make available to any one securities affiliate and all securities affiliates. This would ap-
pear to be an essential element of protection for the bank to prevent uncontrolled financial investment in the activities of its securities affiliates. A corresponding protection that should be included in the regulation of the various types and amounts of financial dealings that will be permitted between the banks and securities affiliates is to absolutely prohibit the bank from acquiring any assets from its affiliates that would expose the bank to an unsafe and unsound condition.

The requirement of adequate security for all extensions of credit between banks and affiliates is also an essential protection for interaffiliate regulation. For this to be an effective security, the acceptability of the collateral should be based on independent market valuation of collateral and the amount of the loan extended to the affiliate. It should also prohibit the acceptance of any collateral where the value of the collateral is solely dependent on the financial condition of the affiliate. By basing collateral acceptability on these criteria, the bank loans and credit extensions to affiliates are highly secure and the collateral requirements are practical.

The final protection to be mentioned and perhaps the most important is the establishment of a satisfactory examination system of securities affiliates that works simultaneously with the examination of banks. This type of structural safeguard and common or dual regulation of the banks and their securities affiliates would be the most effective method of assuring industry sensitivity to achieve arm's-length dealings between banks and their securities affiliates.

As a prototype of the interaffiliate statute, Section 23A not only serves as the model for developing similar statutes but it can also be studied to determine if effective regulation and compliance under such a provision is possible. This question is particularly important to the opponents to Glass-Steagall Act reform, who have expressed doubts about the regulatory success of this type of statute. Accordingly, a survey of the regulatory actions of the Board concerning Section 23A since the enactment of the 1982 amendments will identify both the types and extent of regulatory and compliance problems that might be encountered under a similar provision.
Section 23A: Regulation and Compliance

One of the major reasons for the 1982 amendments to Section 23A was to clarify the provision so that compliance by the banking industry would be easier. The success of these amendments can be best judged by the number of interpretive letters the Board has issued in response to inquiries for clarification that it has received from the industry since 1982. During this period, the Board has issued less than thirty interpretive letters concerning Section 23A, which can be described as de minimus. Accordingly, one might conclude from this that industry compliance under Section 23A has been made easier as a result of the 1982 amendments.

Most of these letters are responses to questions requiring further clarification of the meaning of fundamental terms such as affiliate, covered transaction, and low-quality assets and questions concerning the collateral requirements of Section 23A. The inquiries are not complex, and the responses by the Board staff directly emanate from the language and legislative history of the provision. As in the case of industry compliance, it appears that Board interpretation and regulation of Section 23A is not difficult. Although the inquiries and responses are not complex, the letters are useful because the responses are deliberate in reiterating the fundamental purposes and principles of Section 23A and reveal how the Board as a banking regulatory agency interprets and administers this type of interaffiliate statute.

Affiliate

The Board has received relatively few questions concerning the scope of the term affiliate as defined under Section 23A. The responses by Board staff are uniform in stating that the primary statutory basis for regulation under Section 23A is the element of common control between the bank and the affiliate. These responses also address exceptions to affiliate

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42 The Board has primary statutory authority under § 23A, 12 U.S.C. § 371c(e), to issue "regulations and orders, including definitions consistent with § 23A as may be necessary to administer and carry out the purposes of this section."
status, which are permitted where banking regulation and examination safeguards are built into the relationship between the bank and the entity with which it proposes to enter into a covered transaction. As already indicated, these exceptions typically apply to certain nonbank subsidiaries that engage "solely" in providing operational service for the bank and sister banks within the same holding company system.

One of the first interpretive letters issued by the Board after the 1982 amendments addressed a question concerning the affiliate relationship between a member bank and a mortgage banking company that were interlocked by an individual who also served as the chairman of the board and a director and was a noncontrolling shareholder of the bank’s parent bank holding company. The individual’s ownership of the mortgage banking company was in excess of 25 percent of the company’s voting shares and only 5.5 percent of the voting shares of the parent holding company. Board staff noted that as the term affiliate is defined under Section 23A “a company is deemed to be an affiliate of a member bank if it is controlled by shareholders who control the member bank and any company that controls the member bank.” Because the individual interlock did not have a controlling interest in both the mortgage banking company and the member bank, or its parent holding company, either through a control of 25 percent or more of a class of voting shares or control over the election of a majority of the directors, the Board staff opined that the mortgage banking company was not an affiliate under Section 23A.

Although the element of common control between a bank and a business entity is crucial for affiliate status, it is not determinative of affiliate status where the relationship is such that the business entity functions like a department within the

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43 Letter from J. Virgil Mattingly, Jr., to Jonathan Joseph, Esq. (Nov. 7, 1983).
44 Id.
45 The term control as defined under § 23A requires that the shareholder "directly or indirectly, or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the other company" or "controls in any manner the election of a majority of the directors or trustees of the other company." 12 U.S.C. §§ 371c(b)(3)(A)(i), 371c(b)(3)(A)(ii).
bank and exists solely to perform operational services for the bank, such as holding the premises of the bank, conducting a safe deposit business, or holding obligations of the United States or its agencies or those obligations that are fully guaranteed by the United States. Accordingly, a member bank’s proposed purchase of real estate from a partnership formed for the sole purpose of leasing property for the bank’s premises, and that was owned by six of the eight members of the board of directors of the bank, would not be subject to the restrictions of Section 23A. Although "a purchase of assets" is a covered transaction under Section 23A, the bank’s purchase of the real estate from the partnership would not be subject to Section 23A because the partnership did not qualify as an affiliate. Thus, the purchase of the title of the property from the partnership to build a permanent bank office did not fall within the scope of Section 23A. However, once the property was purchased from the partnership, the partnership would be considered an affiliate because it would no longer exist solely for the purpose of holding property for the bank’s premises, and all future transactions between the bank and the partnership would be subject to the restrictions of Section 23A.

A similar exemption from the restrictions of Section 23A applies in the case of covered transactions between sister banks within the same holding company system. Although sister banks qualify as affiliates under Section 23A, they are exempt from the restrictions of Section 23A because sister banks are viewed as branches of one another and are treated like the same entity. Moreover, financial transactions between the sister banks are not regarded as threatening to bank safety and soundness because both banks will be subject to a similar, if not the same, regulatory and examination oversight by state and federal banking agencies. This exemption, how-

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46 12 U.S.C. § 371c(b)(2); see note 29 supra.
47 Letter from J. Virgil Mattingly, Jr., to Mark Aldrich, Esq. (June 20, 1986).
48 12 U.S.C. § 371c(b)(7)(C); see note 35 supra.
49 12 U.S.C. § 371c(d)(1); see previous discussion at section entitled "Exemption of Sister Banks."
ever, does not apply to foreign banks because they do not fall within the definition of bank under Section 23A. The Board has issued an interpretive letter on this matter stating that a covered transaction between a national bank and a branch bank of its foreign parent holding company would be subject to Section 23A.

In its opinion letter, Board staff cited the legislative history of Section 23A, noting:

Congress did not intend to include a foreign bank within the definition of bank because of the broad range of activities performed by foreign banks, including activities impermissible to domestic banks. Transactions between a bank and a parent holding company that is a foreign bank are restricted in the same manner as transactions between the bank and any nonbank affiliate. This provision recognizes that foreign banks can often engage in activities impermissible to domestic banks and should be treated like nonbank affiliates for purposes of section 23A. S. Rep. No. 536, 97th Cong., 2nd Sess., 31.

In a more recent request for a determination of affiliate status within a holding company system, the Board noted that two banks were affiliates of one another where the first bank was wholly owned by a parent holding company that only held 24 percent of the second bank, less than the 25 percent required for control under Section 23A. The Board found that an affiliate relationship existed because the parent holding company of the first bank also held 100 percent interest in the second bank’s parent holding company, which owned the remaining 76 percent of the second bank’s voting stock. The Board held that the second bank was an affiliate of the first bank because the first bank’s parent holding company owned the 76 percent of the second bank’s stock through its sole ownership of the second bank’s parent holding company, and thus controlled both the first bank and the second bank.

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51 Letter from William W. Wiles to Barry Swart (March 19, 1984).
52 Id.
54 Letter from J. Virgil Mattingly, Jr., to Jason H.P. Kravitt, Esq. (Jan. 15, 1988).
Covered Transactions

The interpretive letters that the Board has issued since 1982 concerning covered transactions have addressed basic questions about the scope of coverage, when covered transactions are exempt from Section 23A restrictions, and how to value covered transactions for purposes of satisfying the collateral requirements under Section 23A. As stated earlier, the term covered transaction was expanded under the 1982 amendments to include virtually every transaction in which a bank extends or obligates its financial resources for the purposes of providing credit to benefit an affiliate. Certain covered transactions are exempt from the restrictions of Section 23A where it is clear that the bank's decision to provide credit is not influenced by the affiliate relationship and is at arm's length, and also in cases where the loan is fully secured and significantly minimizes the bank's risks of loss.

The Board has determined that a bank's participation in a lease financing agreement with an affiliate constitutes a covered transaction where the lease is the equivalent of a mortgage loan. Accordingly, the bank's participation in the lease financing agreement would be the same as the bank's participating in a mortgage loan with the affiliate. Under this arrangement, the affiliate forwards an application for lease financing for one of its customers to the bank, which then makes a credit evaluation of the lessee and the proposed transaction and notifies the affiliate of its approval or disapproval of the credit application. In the event of approval, the affiliate would prepare all of the documentation for the leasing transaction and the contracts to purchase the property leased and would deliver the property to the customer. The monies used to acquire the property to be leased are provided for by the bank. The affiliate, as the lessor and shown as the owner of the property on all documents, subsequently assigns the lease to the bank, transferring all rights, title, and interest in the leased property to the bank, which are booked as assets of

56 This transaction would constitute a purchase of an affiliate's asset and be deemed a covered transaction under § 23A, 12 U.S.C. § 371c(b)(7)(C).
the bank. At the end of the lease term, the bank enjoys or suffers any profit or loss incurred in the sale of the equipment. Although the Board opined that this was a covered transaction, it noted that the transaction would be exempt from the restrictions of Section 23A if the member bank’s commitment to participate in or to purchase the lease financing agreement is obtained by the affiliate before the affiliate has committed to make the lease and is based on the bank’s independent evaluation of the creditworthiness of the lessee.57

Similarly, the Board has also held that a bank’s purchase of a 90 percent participation in a loan portfolio purchase initiated by its affiliate from a third-party nonaffiliate to be a covered transaction.58 Generally, a bank’s acquisition of assets from a third-party nonaffiliate would not qualify as a covered transaction. However, because an affiliate was involved in the acquisition, the Board felt that under this arrangement the bank might be motivated to participate in the affiliate’s purchase of these assets by its desire to alleviate the capital needs of the affiliate rather than by the merits of the proposed transaction. Yet, if it is clear that the bank’s participation occurred at the inception of the original transaction between the bank’s affiliate and the unaffiliated third party and included an independent evaluation of the proposed acquisition by the bank, it would be exempt from the restrictions of Section 23A.59

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57 This position was based on a prior interpretation of the Board at 12 C.F.R. § 250.250. In this interpretation, the Board states that a member bank’s purchase of or participation in a loan “originated” by a mortgage banking affiliate should be regarded as an “extension of credit” by the bank to the affiliate. It also noted that such a purchase or participation would not be an extension of credit to the affiliate where:

[T]he member bank’s commitment to purchase the loan, or a participation therein, is obtained by the affiliate within the context of a proposed transaction or series of proposed transactions, in anticipation of the affiliate’s commitment to make such loan(s), and is based upon the bank’s independent evaluation of the credit worthiness of the mortgagor(s). In these . . . circumstances, the member bank would be taking advantage of an investment opportunity rather than being impelled by any improper incentive to alleviate working capital needs of the affiliate that are directly attributable to excessive outstanding commitments (emphasis added).


59 See 12 C.F.R. § 250.250; see also Letter from Michael Bradfield to Jeffrey C. Gerrish (Jan. 21, 1988). The Board staff opined that a member bank’s purchase of loans from its holding company’s industrial loan and thrift subsidiary was not exempt from the quantitative restrictions of § 23A. Staff noted that because the loans purchased were made by the loan
Another transaction that is exempt from Section 23A restrictions is a bank's acquisition of an affiliate's asset that has a "readily identifiable and publicly available market quotation and [that is] purchased at that quotation." As with the other exemptions from Section 23A restrictions, the transaction must demonstrate that the bank's credit extension is not biased in favor of the affiliate and involves an independent evaluation. The Board has determined, however, that a bank's purchase of the marketable securities issued by an affiliate does not come within this exemption, stating that the purchase of an affiliate's marketable assets does not include the securities of the affiliate.

Although the securities of an unaffiliated third party held by an affiliate are the assets of the affiliate, and are treated as such under Section 23A, an affiliate's own securities represent the capital of the affiliate, do not represent an asset of the affiliate, and do not qualify for the exemption. Instead, this transaction more definitely qualifies as the covered transaction classified as a "purchase or an investment in securities issued by an affiliate." An additional exemption that has been the subject of inquiry provides that covered transactions such as loans, extensions of credit, and guarantees are not subject to the restrictions of Section 23A if they are fully secured by "a segregated, earmarked deposit account with the member bank." This exemption is permitted under Section 23A because the deposit account serves as collateral for the loan, credit extension, or guarantee and thus significantly reduces any risk to the bank that might result from the transaction. Accordingly, the Board has determined that a bank holding company proposal to acquire a controlling interest in a

and thrift company only in cases where the Bank agreed to fund all of the loans, it did not qualify for the exceptions to quantitative restrictions pursuant to Board interpretation. 12 C.F.R. § 250.250. This was based on the fact that the bank would have been the "sole method of funding" for the loan and thrift's operations. Because of the "lack of a source of independent funding for the loans, there [was] a danger that Bank's purchase of the loans [would have been] motivated by a desire to alleviate capital needs of an affiliate rather than by the merits of the proposed transactions."

60 12 U.S.C. § 371c(d)(6); see note 37 supra.
member bank through a capital investment in the bank’s newly issued common stock, funded by an unaffiliated bank with a ten-year, fixed-rate loan that was collateralized by the shares of the bank’s stock and guaranteed by the bank falls within this exemption if the guarantee is fully secured by a segregated, earmarked deposit account with the bank.64 This collateral requirement is satisfied if the capital injection by the holding company into the bank in the amount of the loan would protect the bank from harm that might flow from the bank’s guarantee of the loan. The Board viewed the investment as a permanent injection of capital in the bank and one designed to strengthen the bank. Moreover, the Board found the capital injection to more than satisfy the exemption requirements because the funds for which the guarantee was given would flow to the bank in the form of an increase in its capital accounts rather than merely as a deposit.65

A similar inquiry involving a bank holding company reorganization included a proposal to purchase the assets of an Edge Act Corporation by a domestic bank, both of which were affiliated through a bank holding company.66 The assets to be purchased under this proposal were the commercial loans held by the Edge Act Corporation. Although such covered transactions between affiliated domestic banks are exempt from the quantitative restrictions of Section 23A,67 Congress did not extend this exemption to transactions between a domestic bank and an affiliated Edge Act Corporation. Nevertheless, such a transaction could have been structured to qualify for the exemption provided for covered transactions that are fully secured by segregated, earmarked cash deposits in the bank.68

The valuation of covered transactions for the purpose of satisfying the quantitative limitations of Section 23A has also been an issue for Board interpretation.69 In this particular

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64 Letter from Michael Bradfield to Richard Randal (Jan. 9, 1983).
65 Id.
66 Letter from James McAftee to Raul J. Valdes-Fauli, Esq. (June 3, 1985).
69 Letter from J. Virgil Mattingly, Jr., to Kenni B. Merritt, Esq. (March 19, 1984).
case, a member bank had accepted the securities of an affiliate as collateral for a loan that the bank had made to an unaffiliated third party, which is a covered transaction under Section 23A and would be subject to the quantitative limitations thereunder. A practical question arises concerning how to value a covered transaction for purposes of achieving compliance with the quantitative limitations, that is, whether the value of the transaction is to be determined from the amount of the loan or from the value of the collateral pledged. Board staff interpreted Section 23A as being concerned with the loan made by the member bank to or for the benefit of the affiliate, and thus it is the amount of funds being loaned by the member bank to the unaffiliated third party that is the proper way to measure the value of the covered transaction.

Low-Quality Asset

Another significant aspect of the prohibitions of Section 23A is the absolute restriction against a bank’s acquisition of low-quality assets from an affiliate. The low-quality asset is one that would be determined by bank examiners to be substandard, or doubtful, or loss, and an asset that is likely to be uncollectible. The definition of low-quality asset is to be applied to all of the various covered transactions that banks may enter into under Section 23A.

An interesting question faced by the Board was how to apply Section 23A in an event that a nonrecourse loan par-
ticipation between a member bank and the participating bank affiliate becomes a low-quality asset one year after the loan and the participation were made. The Board was asked to determine whether the participating bank affiliate would be able to participate in the renewal of the loan once it had become a low-quality asset, whether the bank affiliate would have to renew its participation in the loan if the member bank renewed the loan, and whether the member bank would have to repurchase the bank affiliate’s participation in the loan in the event that the bank affiliate does not want to participate in the renewal of the loan. Board staff opined that because the purchase of low-quality assets is prohibited under Section 23A, the bank affiliate “could not” be required to renew the participation if the member bank renewed the loan and that nothing in Section 23A would require the member bank to repurchase the participation in the event the bank affiliate did not participate in the renewal.

However, the Board concluded that in limited circumstances, a participation in the renewal of a loan that has become a low-quality asset would not be prohibited. In such cases, the renewal of such loan would result in minimizing potential losses for both the originating and participating banks and that in these cases it would be contrary to the purposes of Section 23A to prohibit such a transaction when “sound banking judgment” may deem it necessary for the renewal to protect the banks from loss. This exception is permissible as long as the loan was not a low-quality asset at the time of the origination and the participating bank does not assume more than its original proportionate share of the credit extension.

Collateral Requirements

As noted earlier, the types of collateral eligible to serve as security for covered transactions under Section 23A were expanded under the 1982 amendments in order to make loans

and credit extensions between banks and their affiliates more possible and practical. 75 These amendments also imposed certain limitations on a bank's ability to accept securities issued by an affiliate as collateral for a loan or extension of credit to protect a bank's security in the event the affiliate's financial condition suffered while the loan was still outstanding, which would devalue the securities offered as collateral. 76 Although the amendments are fairly clear and straightforward, the Board issued two opinions that are significant in providing further clarification of the collateral requirement and its limitations.

The first of such letters involved a question regarding the acceptability of securities issued by an affiliate as collateral for a loan by a bank to a third person or unaffiliated company. A member bank's acceptance of the securities of an affiliate as collateral for a loan or extension of credit to any person or company qualifies as a covered transaction under Section 23A and is subject to the quantitative limitations thereunder. 77 However, this covered transaction is not included in the list of transactions that are subject to the collateral requirements of Section 23A. 78 Because the loan in this case was not made to the affiliate or on behalf of the affiliate, the transaction was not subject to the collateral requirements of Section 23A. Nevertheless, a bank is absolutely prohibited from accepting the securities of its affiliate as collateral for a loan to that affiliate or to any of its other affiliates. 79 The reason for this restriction is that if the affiliate's financial condition suffers and it defaults on its loan with the bank, its securities will also decline in value, leaving the bank severely insecure with respect to that loan.

The other opinion letter addressed an inquiry concerning the acceptability of real estate and leaseholds as security for a

75 12 U.S.C. § 371c(c)(1); see previous discussion at section entitled "Collateral Requirements."
76 12 U.S.C. §§ 371c(b)(7)(D), 371c(c)(4); see previous discussion at section entitled "Collateral Requirements."
77 Letter from J. Virgil Mattingly, Jr., to Paul Bo chicchio (March 22, 1984).
loan between a bank and its affiliate. In this case, a parent bank holding company proposed to build a new bank building for its two subsidiary banks and to finance the building construction with loans provided by the two banks. To satisfy the collateral requirements of Section 23A, the holding company proposed to offer the bank building and leases it held with the subsidiary banks as collateral. Board staff opined that the real estate interest in the bank building was acceptable collateral regardless of the fact that it was the subject of the loan. However, the leasehold were not acceptable because they were between a bank and its affiliated parent holding company, which is similar to the non-arm’s-length relationships that are the focus of Section 23A restrictions. Accordingly, the Board felt that the leases would raise the same concerns addressed under Section 23A and “would not provide adequate security against the risks inherent in a covered transaction.”

The Board has stated that mortgage servicing rights do not qualify as acceptable collateral for purposes of Section 23A. It was determined that this asset would not be considered personal property for purposes of Section 23A, which permits a covered transaction to be secured up to 130 percent of its value with collateral consisting of “stock, leases, or other real or personal property.” Board staff stated that this mortgage servicing right was not the type of personal property contemplated by Congress when it included other personal property as eligible collateral under the 1982 amendments. It was noted that mortgage servicing rights presented “serious supervisory concerns” because of the difficulty in accurately valuing such rights; the difficulty the bank would have in selling such rights in the event that the affiliate, from which such rights are purchased, defaulted on the loan being secured by the collateral; and the fact that such rights are not

80 Letter from J. Virgil Mattingly, Jr., to Timothy Carlin (June 19, 1984).
81 Id.
82 Id.
83 Letter from Michael Bradfield to Gail Runnfeldt (Aug. 31, 1987).
automatically transferable, requiring the loan holder to give its permission for any transfers.

Conclusion

Section 23A originated as an important part of the congressional armor against the speculative and unbridled lending practices of banks prior to the crisis of 1929. It can truly be regarded as the protective shield against biased and imprudent dealings between banks and their closely related affiliates. Because of regulatory commitment to the mission of Section 23A and sensitivity to its limitations and inadequacies as originally enacted, legislative revision has culminated in an effective and complete interaffiliate statute from which much can be learned and borrowed when considering the proposed regulation of dealings between banks and securities affiliates.

The success of such legislation will depend on what is learned from Section 23A and how it originated and evolved into an effective interaffiliate statute. From this analytical study of Section 23A as the interaffiliate prototype, it becomes most clear that any discussion concerning the feasibility of interaffiliate regulation of banks and securities affiliates, and the formation of such a statute, must certainly begin with and incorporate the fundamental elements of Section 23A—the interaffiliate prototype:

- There should be a complete identification of the kinds of relationships between a bank and its securities affiliate that are not likely to be at arm's length. This may include control relationships and noncontrol relationships in which the bank may have some advisory, financial, or competitive interests that could affect its banking judgment.

- There should be a complete identification of the types of financial transactions that could occur between the bank and the securities affiliate in which the bank's financial resources could be at risk for the benefit of the affiliate.

- There should be a limit against the amount of loans or extensions of credit that a bank may make to any one securities affiliate or to all of its securities affiliates.
There should be a requirement that all loans or extensions of credit between the bank and its securities affiliate be secured. This requirement should also include adequate safeguards to ensure that the value of this security is sustained for the duration of the loan.

There should also be a satisfactory and complementary examination system of the securities affiliate in conjunction with the bank.

It is the conclusion of this article that effective regulation of interaffiliate transactions between banks and securities affiliates is feasible. This conclusion is based on the fact that the restriction of interaffiliate transactions between banks and their affiliated companies is a familiar and long-standing requirement of banking regulation. It is a statutory requirement that both the industry and the regulators have come to understand and live with. Accordingly, this type of regulation should be effectively implemented and complied with as the banking industry enters a new era of financial service expansion.