ABCs of Banking Law 2024

Prudential Limitations and Safety & Soundness

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March 26, 2024

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AFFILIATE TRANSACTIONS

Sections 23A & 23B

"*Sections 23A and 23B of the Federal Reserve Act are two of the most important statutory protections against a bank suffering losses because of its transactions with affiliates and, correspondingly, are two of the most effective means of limiting the ability of a bank to transfer to its affiliates the subsidy arising from the bank's access to the Federal safety net.*"

FRB's Reg W Notice of Proposed Rulemaking (May 11, 2001)

"*Among the most important tools that U.S. bank regulators have to protect the safety and soundness of U.S. banks are the legal restrictions that limit the ability of a bank to lend to affiliates.*"

Scott G. Alvarez, Former General Counsel, FRB (April 24, 2008)

Section 23A – Covered Transactions

- Section 23A (12 USC § 371c) applies to a “covered transaction” between a bank and its affiliate. “Covered transactions” include:
- Loans to the affiliate
- Purchase of assets from the affiliate (including credit derivative transactions)
- Purchase of an affiliate’s securities or investments in the affiliate
- Acceptance of the affiliate’s securities as collateral
- Third party guarantees issued on behalf of the affiliate

Section 23A – Covered Transactions (cont'd)

- Effective July 21, 2012, under Dodd-Frank § 608, "covered transaction" also includes
  - securities lending or borrowing transactions,
  - repo and reverse repo transactions, and
  - all derivative transactions

  to the extent that the bank has "credit exposure" to the affiliate

- Section 23A also has an "attribution rule," deeming transactions with a third party to be subject to Section 23A if the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate

Section 23A - Who is an "Affiliate"

- "Affiliate" includes:
  - any company controlled by the bank, controlling the bank, or under common control with the bank
    - "Control" is the Bank Holding Company Act definition:
    - Ownership of 25% or more of a voting class
    - Control over the election of a majority of the directors or trustees
    - Otherwise having a "controlling influence" over the management or policies of the company
  - any company that is sponsored or advised by the bank on a contractual basis, or any investment fund for which the bank or an affiliate is the adviser
- "Affiliate" generally does *not* include a controlled subsidiary of the bank

Section 23A – Quantitative Limits

- Section 23A imposes "quantitative limits" on the amount of covered transactions that may be outstanding.
- These limits are:
  - 10% of the bank's capital stock and surplus, for covered transactions with any *one* affiliate; and
  - 20% of the bank's capital stock and surplus for covered transactions with *all* affiliates

- Section 23A's implementing regulation, Regulation W (12 CFR Part 223) has detailed provisions regarding how these limits are to be calculated and how the covered transactions are to be valued

Section 23A – Collateral Requirements

- Section 23A requires that any extension of credit to, or guarantee issued on behalf of, an affiliate, or the acceptance of an affiliate's letter of credit, be collateralized from 100% to 130% of the value of the transaction, depending on the nature of the collateral
  - Section 23A's implementing regulation, Regulation W (12 CFR Part 223) has detailed provisions regarding how the value of the collateral is to be calculated, valued, and replaced

- Effective July 21, 2012, Dodd-Frank § 608 requires that the collateral requirements apply for the duration of the extension of credit, not just at the outset

Section 23A – Qualitative Limits

- Section 23A imposes “qualitative limits” on certain covered transactions:
- the bank may not purchase any “low quality asset” from an affiliate
- the bank may not accept a low quality asset as collateral for an extension of credit to, guarantee on behalf of, or acceptance of a letter or credit from, an affiliate

- “Low quality asset” means:
- substandard, doubtful, or loss assets
- assets currently on nonaccrual
- re-aged, re-negotiated or comprises assets
- assets that are 30 or more days past due

Section 23A – Safe and Sound Terms

- Section 23A requires that any covered transaction "be on terms and conditions that are consistent with safe and sound banking practices"

- All covered transactions must also comply with Section 23B

Section 23A – Exemptions

- Section 23A (and Reg W) exempts in whole or in part:
- transactions between sister banks (other than LQAs)
- loans or extensions of credit fully secured by Treasuries, Agencies, or segregated earmarked deposit accounts
- purchasing loans originally underwritten by the bank or sold by the bank to the affiliate with recourse or subject to repurchase
- purchasing assets having a readily identifiable and publicly available market quotation
- transactions exempted by order
- intraday extensions of credit
- certain riskless principal and prime brokerage transactions

Section 23B – Scope

- Section 23B (12 USC § 371c) applies to:
  - any "covered transaction"
  - any sale of assets or securities by a bank *to* an affiliate
  - the payment of money of furnishing of services to an affiliate
  - any transaction in which the affiliate acts as the bank's agent or broker and receives a fee

- Section 23B also has an "attribution rule," encompassing transactions with third parties if any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate

Section 23B – Arm's Length

- Section 23B requires that all such transactions be:
- on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies; or
- in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies

Section 23B – Other Requirements

- Section 23B generally prohibits:
- A bank, in its fiduciary capacity, purchasing securities issued by an affiliate
- A bank purchasing securities during the existence of an underwriting or selling syndicate, if an affiliate is the principal underwriter
- A bank advertising or entering into an agreement implying or suggesting that the bank will be responsible for the obligations of the affiliate

Section 23B – Exemptions

- Section 23B (and Reg W) provide certain exemptions similar to those applicable to Section 23A, including exemptions by order

- Note that Section 23B exempts sister bank transactions

“Super 23A” and “Super 23B”

- The Volcker Rule adds special affiliate transaction rules with respect to transactions between:

– a private equity or hedge fund that is advised, managed, sponsored, or organized and offered by a banking entity, and

  – the banking entity (or any of its affiliates)

- A transaction between such the fund and such entities is *barred* by Super 23A if the transaction *would* be a covered transaction if the fund were a “bank” and the banking entity were a nonbank affiliate
- Super 23A thus bans loans to, guarantees on behalf of, investments in, or purchases of assets from, such funds
- Super 23B requires all transactions with such funds to be at arms’ length

INSIDER TRANSACTIONS

Scope of Regulation O

- Regulation O (12 CFR Part 215) restricts a bank's extensions of credit to "insiders"
- "Insiders" include:
  - Directors (including immediate family members)
  - Executive officers
    - Applies to certain listed positions, unless excluded by resolution
  - Principal shareholders (including family members)
    - Though recent discussion of certain large fund complexes and applicability if fund complex controls more than 10% of bank or BHC. See, e.g., FRB SR Letter 21-20
  - And any "related interests" of any of the foregoing
    - "Related interests" include controlled companies / PACs
- Covers insiders of the bank **and** insiders of any affiliate
  - Directors and executive officers of sister companies (but not parent companies) can be excluded by resolution

Scope of Regulation O (cont'd)

- Applies to "extensions of credit"
  - Include loans, repos, discounting, overdraft coverage, advances on salary beyond 30 days, etc.
  - Does not include certain credit card accounts with lines below $15K or overdraft programs with lines below $5K
  - Reg O also has a "tangible economic benefit" provision capturing transactions with third parties (a concept similar to Section 23A's attribution rule)

- Reg O effectively requires extensive internal recordkeeping and information gathering, and adoption of Reg O policies, to prevent inadvertent violations

No Favorable Terms

- Prohibits extensions of credit to insiders that are on terms more favorable than those made available to the public generally or that involve more than the normal risk of repayment
  - Exception for extensions of credit under programs if on terms widely available to the bank's employees

Reg O Limits on Loans to Insiders

Individual Limit:

- Reg O requires board of directors' approval for any extension of credit to an insider (including their related interests) that exceeds certain limits
  - 5% of the bank's capital & surplus, up to $500K
    - There is no limit on loans fully secured by Treasuries, Agencies, or deposits

Aggregate Limit:

- Reg O caps extensions of credit to *all* insiders equal to the bank's lending limit
  - 15% of the bank's capital and surplus, plus an additional amount equal to 10% of capital and surplus for extensions of credit that are fully secured

Restrictions on Loans to Executives

Restrictions on loans to the bank's executive officers

- Extensions of credit are capped as follows:
  - No limit on education loans for children
  - No limit on residential owner-occupied first lien loans (and no cash-out refis)
  - No limit on loans fully secured by Treasuries, Agencies, or deposits
  - Otherwise, transactions are limited to 2.5% of the bank's capital & surplus, but may not exceed $100K
- All executive officer loans must be reported to the board of directors
- All executive officer loans must be callable by the bank if executive officer's loans from *other* banks exceed the thresholds above

Recent Reg. O Interagency No-Action Position Regarding Investment Funds

From the December, 2022 Interagency Statement extending prior relief (available at: https://www.occ.treas.gov/news-issuances/bulletins/2022/bulletin-2022-27a.pdf):

- The agencies will continue to exercise discretion in not bringing action against principal shareholder fund complexes and banks for extensions of credit to fund complex-controlled portfolio companies that would otherwise violate Regulation O, provided the principal shareholder fund complexes and banks satisfy certain criteria that ensure the principal shareholder fund complex does not control the bank.
- The agencies will continue to not take action against banks for failure to report, for purposes of section 363.2 of the FDIC's regulations (12 CFR 363.2), extensions of credit that would otherwise violate Regulation O but are covered by the interagency statement.
- The agencies are providing this no-action position while the Federal Reserve Board, in consultation with the other agencies, considers whether to amend Regulation O to address this issue.
- This statement will cease to be effective on the sooner of January 1, 2024, or on the effective date of any Federal Reserve Board rule finalizing a revision to Regulation O that addresses the treatment of extensions of credit by a bank to fund complex-controlled portfolio companies that are insiders of the bank.

LENDING LIMITS

Bank Lending Limits

- National banks are subject to lending limits (or “loans to single borrower restrictions”) pursuant to 12 CFR Part 32 and 12 USC § 84

- State banks are subject to lending limits established under state law, but most states mirror Part 32

- Part 32 limits a bank’s loans and extensions of credit to any single borrower to

— 15% of the bank’s capital and surplus, plus

— 10% of the bank’s capital and surplus if fully secured

  - special cap on all loans made to all entities within a single corporate group (equal to 50% of capital and surplus)

Loans and Extensions of Credit

The phrase, “loans and extensions of credit” is broadly defined to include actual extensions of credit, binding loan commitments, securities repurchase agreements, and discounting of commercial paper

- Effective July 21, 2012, Dodd-Frank § 610 expands the definition to include *any* repurchase or pledge agreements, as well as credit exposure created under any derivative transaction, securities lending or borrowing agreement, or reverse repurchase agreement (implementing regulations were issued, effective October 1, 2013)
- Dodd-Frank § 611 requires that state lending limits also encompass this expanded definition

Who is a Single Borrower?

Loans to different entities will be considered a loan to a single borrower in two situations

- "Direct benefit test"
  - the proceeds of the loan to one person will be transferred to the other person (other than to purchase property or services)
- "Common enterprise test"
  - the expected source of repayment from both borrowers is the same
  - the borrowers are under common control and substantial financial interdependence exists
  - the borrowers are acquirers in a leveraged buy-out, or
  - when the OCC otherwise determines
- Special rules apply to loans to partnerships, JVs, and foreign governments

Holding Company Lending Limits

- For BHCs with assets greater than $50B, Dodd-Frank § 165(e) required the FRB, by July 21, 2013, to establish a concentration limit equivalent to 25% of a BHC's capital stock and surplus, applicable to all "credit exposure" by a BHC (and its affiliates) to any counterparty (and its affiliates).
  - In June 2018 the FRB adopted a final regulation implementing Section 165(e), effective October 5, 2018, applicable to $250B+ BHCs (and certain U.S. operations of $250B+ FBOs), referred to as "covered companies"
  - The final regulation established a general limit of 25% of Tier 1 capital, but imposed a lower limit (15%) applicable US GSIBs with respect to their credit exposure to other GSIBs

Holding Company Lending Limits (cont'd)

- Generally, credit exposure is calculated on a "net" basis (*i.e.*, taking into account any collateral or other credit mitigants)
- If a covered company exposure to any one counterparty exceeds 5% of Tier 1 capital, the regulation requires extensive due diligence regarding whether

  > "the counterparty is economically interdependent with one or more other counterparties of the covered company and … to determine whether the counterparty is connected by a control relationship with one or more other counterparties."

- Economic interdependence can exist based on credit relationships, business (*e.g.*, output or production) relationships, common sources of income, common sources of funding, etc.
- From a practicable standpoint this requirement discourages any covered company from exceeding the 5% threshold

Closing

QUESTIONS ?