



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND
REGULATION

SR 03-2
January 9, 2003

**TO THE OFFICER IN CHARGE OF SUPERVISION AND
APPROPRIATE SUPERVISORY AND
EXAMINATION STAFF AT EACH FEDERAL
RESERVE BANK AND TO DOMESTIC AND
FOREIGN BANKING ORGANIZATIONS
SUPERVISED BY THE FEDERAL RESERVE**

**SUBJECT: Adoption of Regulation W Implementing Sections 23A and 23B of the
Federal Reserve Act**

On December 12, 2002, Regulation W, the rule that comprehensively implements sections 23A and 23B of the Federal Reserve Act, was published in the *Federal Register*.¹ The rule is effective April 1, 2003.

Sections 23A and 23B and Regulation W limit the risks to a bank from transactions between the bank and its affiliates and limit the ability of a bank to transfer to its affiliates the subsidy arising from the bank's access to the Federal safety net (i.e., lower cost insured deposits, the payment system, and the discount window).² The statute and rule accomplish these purposes by imposing quantitative and qualitative limits on the ability of a bank to extend credit to, or engage in certain other transactions with, an affiliate. Transactions between a bank and a nonaffiliate that benefit an affiliate of the bank are covered by the statute and regulation as well, through the well-established "attribution" principle. However, certain transactions that generally do not expose a bank to undue risk or abuse the safety net are exempted from coverage under Regulation W.

The Gramm-Leach-Bliley Act (GLBA) increased the range of affiliations permitted to banking organizations. A key premise of GLBA was that sections 23A and 23B would limit the risk to depository institutions from these broader affiliations and eliminate the need for extensive prior review by the bank regulatory agencies. Given the enhanced role of sections 23A and 23B in risk management after GLBA, it is essential that examiners and other supervisory staff review intercompany transactions for compliance with the statutes and Regulation W. Reviews for compliance with the affiliate transaction rules should be frequent and rigorous, and any violations or potential violations should be resolved quickly.

A summary of significant issues addressed in the rule follows. The attached appendix provides a comprehensive review of the rule.

Significant Issues Addressed in Regulation W

Regulation W includes 70 years' worth of interpretive guidance furnished by the Board and its staff concerning statutory requirements that are fairly brief, but extremely complex in application. The following summarizes how the Board resolved nine significant issues addressed by the final rule.

1. Derivatives. The final rule (i) provides that derivative transactions between banks and their affiliates are subject to the market terms requirement of section 23B, and (ii) requires banks to adopt policies and procedures to manage the credit exposure arising from their derivative transactions with affiliates. The final rule does not subject credit exposure arising from bank-affiliate derivatives to the quantitative limits and collateral requirements of section 23A. The final rule also provides that credit derivatives between a bank and a nonaffiliate in which the bank protects the nonaffiliate from a default on, or decline in value of, an obligation of an affiliate of the bank are covered transactions under section 23A.

In the near future, the Board expects to issue a proposed rule that would seek public comment on how, under section 23A, to treat derivative transactions that are the functional equivalent of a loan by a bank to an affiliate or the functional equivalent of an asset purchase by a bank from an affiliate.

2. Intraday Credit. The final rule (i) provides that intraday extensions of credit by a bank to an affiliate are subject to the market terms requirement of section 23B, and (ii) exempts intraday credit extensions by a bank to an affiliate from the quantitative limits and collateral requirements of section 23A if the bank adopts policies and procedures to manage the credit exposure arising from its intraday credit extensions to affiliates and has no reason to believe that the affiliate would have difficulty repaying the credit.

3. Financial Subsidiaries. The final rule provides that financial subsidiaries of a bank are affiliates of the bank. Thus, under the final rule, transactions between a bank and its financial subsidiary, as well as other affiliates, are subject to the requirements of sections 23A and 23B.

In addition to transactions between a bank and its financial subsidiary, certain transactions between an affiliate of a bank and a financial subsidiary of the bank are subject to sections 23A and 23B. Any purchase of, or investment in, the securities of a financial subsidiary of a bank by an affiliate of the bank is treated as a purchase of, or investment in, such securities by the bank. An extension of credit to a financial subsidiary of a bank by an affiliate of the bank is treated as an extension of credit by the bank if the extension of credit is treated as regulatory capital of the financial subsidiary. Other extensions of credit to a financial subsidiary of a bank by an affiliate of the bank may be treated as an extension of credit by the bank to the financial subsidiary if the Board determines, on a case-by-case basis, that such treatment is necessary or appropriate to prevent evasions of the Federal Reserve Act or GLBA.

The final rule, consistent with the law, defines a financial subsidiary as any subsidiary of a national or state chartered bank that engages in an activity not permissible for national banks to conduct directly. The final rule, however, exempts insurance agency subsidiaries of national and state chartered banks from the definition of financial subsidiary because these subsidiaries usually require little funding from their parent bank and generally do not pose a substantial threat to bank safety and soundness. In addition, the final rule exempts subsidiaries of a state chartered bank that engage only in (i) activities permissible for the state chartered bank to conduct directly, or (ii) activities they were lawfully conducting before issuance of the final rule (a grandfather provision for existing subsidiaries).

4. General Purpose Credit Card Exemption. The final rule exempts from section 23A extensions of credit by a bank under a general purpose credit card where the borrower uses the credit to purchase goods or services from an affiliate of the bank. The final rule defines a general purpose credit card as a credit card issued by a bank that is widely accepted by merchants (such as a Visa card or Mastercard) so long as less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the bank.

The final rule generally exempts from the 25 percent test any bank that does not have nonfinancial affiliates, because banks with retail commercial affiliates typically are the banks whose credit cards are used substantially to purchase goods or services from affiliates of the banks. The final rule also exempts from the 25 percent test any widely accepted credit card if the issuer bank can establish to the Board's satisfaction that a minimal percentage of purchases with the card would be purchases from an affiliate of the bank.

5. Foreign Banks. For competitive equity reasons, the final rule applies sections 23A and 23B to transactions between the U.S. branches and agencies of a foreign bank and affiliates of the foreign bank engaged in the United States in several new GLBA activities, including securities underwriting and dealing, insurance underwriting, merchant banking, and insurance company investment. The regulation does not apply sections 23A or 23B to transactions between a U.S. branch or agency of a foreign bank and any other type of affiliate (for example, foreign affiliates or U.S. affiliates engaged in pre-GLBA nonbanking activities), or to transactions between the foreign bank's non-U.S. offices and its U.S. nonbank affiliates. This approach is consistent with the Board's previous application of sections 23A and 23B to section 20 affiliates of foreign banks before GLBA and securities and merchant banking affiliates of foreign banks after GLBA. Of course, sections 23A and 23B and Regulation W apply to a U.S. *bank* subsidiary of a foreign bank in the same manner and to the same extent as they would apply to any other U.S. bank.

6. Section 250.250 Exemption. Since 1974, a bank's purchase of loans from an affiliate has not been subject to section 23A if (i) the bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes the loan, and (ii) the bank commits to purchase the loan prior to the affiliate making the loan (the "250.250 exemption"). The purpose of the exemption was to allow a bank to take advantage of an investment opportunity and not to alleviate the funding needs of an affiliate. By the 1990s, however, some banks were using this exemption to provide nearly all their non-bank lending affiliates' funding. In 1995, to ensure that banks used the 250.250 exemption consistently with its original purpose, Board staff opined that the exemption was not available to any bank whose loan

purchases from an affiliate represented more than 50 percent of the loans made by the affiliate.

The final rule retains the 50 percent test as a general matter but allows the bank's primary federal regulator to reduce the 50 percent threshold prospectively, on a case-by-case basis, if appropriate to protect the safety and soundness of the bank. Concurrent with the adoption of the final Regulation W, the Board is seeking comment on a proposed rule that would limit a bank's purchases of extensions of credit from an affiliate under the exemption to 100 percent of the bank's capital stock and surplus.

7. Affiliated mutual funds. The final rule includes an exemption for loans by a bank to a third party secured by securities issued by a mutual fund affiliate of the bank (subject to a number of conditions).

8. Corporate reorganizations. The final rule contains an exemption that would permit a banking organization to engage more expeditiously in internal reorganization transactions involving a bank's purchase of assets from an affiliate (subject to a number of conditions, including those that the Board traditionally has imposed when granting case-by-case exemptions for such transactions).

9. Valuation rules. The final rule contains new valuation rules for a bank's investments in, and acquisitions of, affiliates.

Reserve Banks should distribute this letter and the attached review of Regulation W to the domestic and foreign banking organizations supervised by the Federal Reserve. Reserve Banks should also ensure that all central points of contact, examiners, and other staff involved in the supervision of banking organizations' lending and investing activities review this SR letter, the attached guidance, and Regulation W, and focus their supervisory activities accordingly.

Should you have any questions concerning this SR letter, please direct them to an appropriate individual noted below. General policy questions should be directed to Michael G. Martinson, Associate Director (202-452-3640), or Molly S. Wassom, Associate Director (202-452-2305). Questions concerning applications-related matters should be directed to Betsy Cross, Deputy Associate Director (202-452-2574), or Katie Cox, Supervisory Financial Analyst (202-452- 2721). All other supervision-related questions should be directed to Mary Frances Monroe, Senior Supervisory Financial Analyst (202-452-5231), or Michael J. Schoenfeld, Senior Supervisory Financial Analyst (202-452-2836). Questions regarding legal interpretations should be directed to Pamela G. Nardolilli, Senior Counsel (202-452-3289), or Mark E. Van Der Weide, Counsel (202-452-2263).

Richard Spillenkothen
Director

Attachment:

[Appendix – Comprehensive Review of Regulation W](#)
(1,316 KB PDF)

Notes:

1. 67 FR 76560, December 12, 2002. The text of the regulation is contained on the Board's public website at www.federalreserve.gov/boarddocs/press/bcreg/2002/20021127/attachment1.pdf. Many of the Board's interpretations of, and staff opinions on, sections 23A and 23B have been incorporated into Regulation W. [Return to text](#)
2. For ease of reference, this SR letter refers to "banks," but insured savings associations are also subject to sections 23A and 23B as if they are banks. [Return to text](#)

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