

## **Application of the Affiliated Transactions Rules to a Proposed Restructuring**

**Summary Conclusion:** OTS will not recommend enforcement action against a federal savings association in connection with the application of the transactions-with-affiliates restrictions of section 23A of the Federal Reserve Act, section 11(a) of the Home Owners' Loan Act, and OTS regulations, based on a transfer of the association's subsidiary to the association's holding company, provided the association complies with certain conditions.

**Date:** July 31, 2001

**Subjects:** Savings and Loan Holding Companies/Change in Control; Affiliate Transactions

P-2001-8

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**Office of Thrift Supervision**

Department of the Treasury

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6251

**P-2001-8**

*Chief Counsel*

July 31, 2001

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Re: Application of the Affiliated Transactions Rules to a Proposed Restructuring

Dear [ ]:

This responds to your recent letter to [ ], Regional Counsel, Office of Thrift Supervision (OTS) on behalf of [ ] (Association), a federal savings association. You request that OTS confirm it will not recommend enforcement action against the Association in connection with the application of the transactions-with-affiliates restrictions imposed by Section 23A of the Federal Reserve Act (FRA),<sup>1</sup> Section 11(a) of the Home Owners' Loan Act (HOLA),<sup>2</sup> and OTS regulations thereunder<sup>3</sup> to a proposed transfer of the Association's subsidiary to the Association's holding company, as described below.

In brief, on the basis of representations made to us, the supervisory determinations made by the OTS [ ] Region (Region) that the transaction would enhance the safety and soundness of the Association, and for the reasons discussed below, we confirm that OTS will not recommend enforcement action against the Association under the foregoing statutes and regulations, provided the Association complies with the conditions set forth below.

<sup>1</sup> 12 U.S.C. § 371c (West 1989 & West Supp. 2000).

<sup>2</sup> 12 U.S.C. § 1468(a) (West Supp. 2000).

<sup>3</sup> 12 C.F.R. §§ 563.41 and 563.42 (2001).

## Background

The Association is a wholly-owned subsidiary of [ ] (Holding Company). [ ] (Corporation) is a wholly-owned subsidiary of the Association and is engaged in the business of real estate development. In the past, the Association has provided loans, made commitments, and extended letters of credit to the Corporation and its subsidiaries and joint ventures identified in Exhibit A to your letter (Corporation Loans). You represent that the Corporation Loans were made in compliance with all applicable laws and regulations, and in accordance with informal commitments entered into with the OTS.

The Association is considering a transaction whereby the Corporation would become a wholly-owned subsidiary of the Holding Company (Proposed Transaction).<sup>4</sup> The Proposed Transaction would be accomplished in the following manner. The Association would transfer the Corporation to the Holding Company by declaring and distributing all of the issued and outstanding shares of Corporation stock to the Holding Company as a dividend.

Upon consummation of the Proposed Transaction, the amount of the Corporation Loans, both individually and when aggregated with all existing covered loans, will equal approximately thirty percent (30%) of the Association's capital stock and surplus.<sup>5</sup>

In connection with the Proposed Transaction, the Association has agreed that the Corporation Loans would not be modified, amended, or renewed, and the Association would not make any further loans to the Corporation or to Corporation-sponsored projects, including joint ventures. The Association also has agreed that it would not engage in any covered transactions with any affiliates until the aggregate amount of covered transactions, including those with the Corporation, falls below twenty percent (20%). As a separate matter, the Association wishes to be able to make loans to officers and directors of the Holding Company and its affiliates, but it commits that these loans would be limited to no more than one percent (1%) of capital and surplus.

OTS supervisory staff in the Region has reviewed the Proposed Transaction and has concluded that it is reasonable, does not pose a safety and soundness risk to the Association, and is in the best interests of the Association. In addition, according to the Region, consummation of the Proposed Transaction will result in a gradual reduction in

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<sup>4</sup> The Proposed transaction is being undertaken at the request of the Region to insulate the Association to a greater degree from the risks associated with the Corporation's real estate development activity and the Corporation Loans.

<sup>5</sup> As of March 31, 2001, the Association had outstanding only \$[ ] of affiliated loans, or 0.04% of capital and surplus.

the thrift's loan exposure over time. The Region also advises that because the Association's investment in the Corporation is already deducted from the Association's regulatory capital, the dividend to the Holding Company will have no adverse impact on the Association's core or risk-based capital.

## Discussion

Under Section 11 of the HOLA, Section 23A of the FRA is applicable to savings associations "in the same manner and to the same extent as if the savings association were a member bank" of the Federal Reserve System. Section 23A generally imposes quantitative and qualitative limits on the amount of "covered transactions,"<sup>6</sup> which include loans, issuances of guarantees, acceptances, letters of credit, and other extensions of credit, between a savings association and its affiliates.<sup>7</sup>

Section 23A imposes two quantitative limits on covered transactions.<sup>8</sup> It generally limits the amount of any covered transaction between a savings association and any one of its affiliates to an amount not in excess of ten percent (10%) of the capital stock and surplus of the savings association. The statute also limits the aggregate amount of covered transactions involving all affiliates to no more than twenty percent (20%) of the savings association's capital stock and surplus. Section 23A also imposes qualitative limits, such as the prohibition on purchasing low quality assets from an affiliate and the requirement that all loans or extensions of credit to an affiliate be appropriately collateralized at the time of the covered transaction. Further, pursuant to Section 11(a)(1)(A) of the HOLA, savings associations may extend credit only to affiliates engaged in activities that the Board of Governors of the Federal Reserve System (FRB) has deemed permissible for bank holding companies.

As you note in your letter, upon consummation of the Proposed Transaction, the Corporation would become an affiliate of the Association, and the outstanding Corporation Loans would represent approximately thirty percent (30%) of the Association's capital and surplus. This would exceed the quantitative restrictions, both for the amount of covered transactions permitted with any single affiliate and for the amount permitted with all affiliates, in the aggregate.

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<sup>6</sup> 12 U.S.C.A. § 371c(b)(7)(A).

<sup>7</sup> 12 U.S.C.A. § 371c(a)(1)(A). Section 23A defines "affiliate" to include any company that controls the savings association and any other company that is controlled by the company that controls the savings association. 12 U.S.C.A. § 371c(b)(1)(a). Generally, subsidiaries of a savings association are not included within the definition of "affiliate." Thus, the Corporation is not currently an affiliate of the Association but would become an affiliate of the Association upon consummation of the Proposed Transaction.

<sup>8</sup> 12 U.S.C.A. § 371c(a)(1). We note that the FRB recently published a proposed rule to codify, and possibly modify several of, its interpretations of Sections 23A and 23B. 66 Federal Register 24186 (May 11, 2001).

We note that you have withdrawn your original request to be permitted to make loans to third parties for the purchase of Corporation's properties after the transfer.<sup>9</sup> We also note that you have clarified that your original request that the Association be permitted to make loans of up to one percent (1%) of capital and surplus to affiliates without regard to the quantitative limits of Section 23A was intended to indicate that the Association wants to preserve the right to make loans of up to that amount to individual directors and officers of affiliates. OTS Supervisory staff in the Region accept the Association's commitment that loans or extensions of credit to directors and officers of the Holding Company and its affiliates will not exceed one percent of capital and surplus, and will comply with applicable statutes and regulations, including 12 C.F.R. Part 215 (Regulation O).

You indicate in your letter that the collateral for most of the Corporation Loans is real estate, which would require a market value of 130% of the amount of the covered transaction to be provided to the Association.<sup>10</sup> You also indicate that some of the Corporation Loans may not meet the collateral requirements of Section 23A.

The FRB has not determined real estate development to be a permissible activity for a bank holding company. As a result, upon consummation of the Proposed Transaction and the transformation of the Corporation from the Association's subsidiary to its affiliate, the Corporation Loans will violate the restrictions against making loans or extensions of credit to an affiliate engaged in activities other than those approved for a bank holding company, which are imposed by Section 11(a)(1)(A) of the HOLA.

When the Corporation Loans were made, Section 23A of the FRA and Section 11(a)(1)(A) of the HOLA did not apply to the transactions, because as a subsidiary of the Association, the Corporation was not an affiliate, and thus not subject to restrictions on transactions with affiliates. The Proposed Transaction would not involve any modification or renewal of the Corporation Loans or any new loans, extensions of credit, letters of credit, or other covered transactions to the Corporation.

As noted in your letter, in specific instances, our office has previously confirmed that we would not recommend enforcement action against a thrift in connection with a restructuring in which a subsidiary of a thrift was transferred to the thrift's holding company, thereby causing the subsidiary to become an affiliate and causing preexisting loans and extensions of credit to the new affiliate to exceed the limitations and

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<sup>9</sup> Such loans would be subject to the quantitative limits to the extent the proceeds of the loans would be used for the benefit of, or transferred to, the Corporation. See e.g., Letter of OTS Chief Counsel, June 7, 1993.

<sup>10</sup> 12 U.S.C. A. § 371c(c)(1)(D).

restrictions of Section 23A where the safety and soundness of the thrift was enhanced.<sup>11</sup> The standards applied in those cases required that (1) the loans and extensions of credit were permissible under the laws and regulations applicable at the time they were made; (2) the restructuring does not involve any modification or renewal of the terms of the loans; and (3) the loans and extensions of credit are counted toward the overall quantitative limitation on covered transactions, so that no new covered transactions with any affiliate are permitted until the aggregate amount decreases below the applicable 20 percent of capital and surplus ceiling.

Based upon our review of the facts as you have presented them, the support of the Region for the Proposed Transaction as improving the safety and soundness of the Association, and previous precedent, we confirm that we would not recommend enforcement action based on Section 23A of the FRA, Section 11(a)(1)(A) of the HOLA, or related OTS regulations in connection with the Proposed Transaction, provided that:

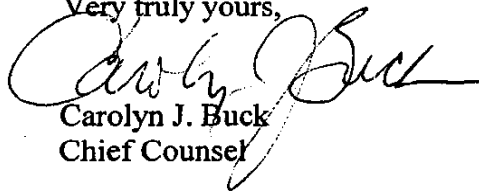
- the Association does not modify, amend, or renew the terms of the existing Corporation Loans;
- the Association does not make, extend, or engage in any new loans, guarantees, letters of credit, extensions of credit, or other covered transactions to or with the Corporation or to Corporation-sponsored projects, including joint ventures, because the Corporation is engaged in an activity (real estate development) the FRB has not deemed permissible for bank holding companies; and
- the Association does not engage in any new covered transactions with any affiliates until the Association's aggregate existing covered transactions, including the Corporation Loans, are reduced to not more than 20% of capital and surplus.

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<sup>11</sup> See e.g., Letters of OTS Chief Counsel, April 18, 1990, July 23, 1990, July 15, 1992, and September 22, 1992.

If you have any questions regarding the foregoing, please do not hesitate to contact Sally Warner Watts, Counsel (Banking and Finance), at (202) 906-7380 or Vicki Hawkins-Jones, Assistant Chief Counsel, at (202) 906-7034.

Very truly yours,

A handwritten signature in black ink, appearing to read "Carolyn J. Buck". The signature is fluid and cursive, with a long horizontal stroke at the end.

Carolyn J. Buck  
Chief Counsel

cc: Regional Directors  
Regional Counsel