



**Interpretive letter #1168  
July 2020**

March 24, 2020

[ ]

Subject: Finding & Order Related to [ ] Section 23A Exemption Request

Dear [ ]:

This is in response to the request the Office of the Comptroller of the Currency (OCC) has received from [ ] (Bank) for an exemption from section 23A of the Federal Reserve Act and Regulation W<sup>1</sup> to allow the Bank to purchase up to [ ] in variable rate demand notes (VRDN) from [ ] (Affiliate), a nonbank, broker-dealer affiliate of the Bank, in excess of the quantitative limits of section 23A and Regulation W.

The VRDNs the Bank intends to purchase from the Affiliate were issued by municipal entities and include a demand feature that allows investors to put the VRDNs to a tender agent acting for the issuer at par plus accrued interest. The VRDNs are enhanced by letters of credit or standby bond purchase agreements provided by the Bank that support the timely payment of principal and interest and the remarketing of VRDNs issued by the municipal entities. The interest rate on the VRDNs is generally reset weekly or daily (depending on the security) by the Affiliate, which serves as the remarketing agent for the VRDNs, based on prevailing market conditions and applicable short-term interest rates. As remarketing agent, the Affiliate is responsible for reselling to investors VRDNs that have been tendered for purchase by an investor.

If the remarketing is not successful, the VRDN holders are entitled to put the VRDNs to the tender agent, which would draw on the liquidity facility provided by the Bank to purchase the VRDNs from the holders that are tendering their notes for purchase.

Because of ongoing disruptions in the municipal securities market resulting from the COVID-19 crisis, liquidity for VRDNs has been severely restricted. Due to these dislocations, [ ] of the municipal VRDNs that are backed by the Bank liquidity facilities could not be

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<sup>1</sup> 12 C.F.R. § 223.

successfully remarketed last week. In order to promote liquidity in the market and prevent adverse consequences for the municipal issuers, the Affiliate purchased these VRDNs and now holds them in inventory. The VRDNs will be remarketed this week, but in light of the ongoing dislocation in the markets, it is possible that this amount, as well as the remaining [ ] of municipal VRDNs backed by Bank liquidity facilities, may not be successfully remarketed this week or on one of the subsequent remarketing dates. With the ongoing market dislocations continuing, the Bank may need to purchase up to [ ] in total of the municipal VRDNs from the Affiliate during the 6-month period between March 25, 2020 and October 25, 2020 (the Proposed Transactions). The Bank proposes to purchase from the affiliate up to approximately [ ] in municipal VRDNs should (i) the remarketing of the VRDNs fail, and (ii) the Affiliate decide to purchase the VRDNs to support the municipal clients and market.

Section 23A and Regulation W limit the aggregate amount of “covered transactions” between a bank and any single affiliate to 10 percent of the bank’s capital stock and surplus and limit the aggregate amount of covered transactions between a bank and all its affiliates to 20 percent of the bank’s capital stock and surplus.<sup>2</sup> “Covered transactions” include the purchase of assets by a bank from an affiliate, the extension of credit by a bank to an affiliate, the issuance of a guarantee by a bank on behalf of an affiliate, and certain other transactions.<sup>3</sup> The statute and regulation also require a bank to secure its extensions of credit to, and guarantees on behalf of, affiliates with prescribed amounts of collateral.<sup>4</sup>

In addition, section 23A and Regulation W treat a transaction by a member bank with any person as 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 under the “attribution rule.”<sup>5</sup>

Because the Affiliate and the Bank are both controlled by [ ] (Holding Company), the Affiliate is an affiliate of the Bank for purposes of section 23A and Regulation W. As a result, the Bank’s purchases of VRDNs from the Affiliate would be covered transactions under section 23A and Regulation W. Under the attribution rule in section 23A and Regulation W, the Bank’s funding of the repurchase of VRDNs from the Affiliate through the Bank’s liquidity facility also would be a covered transaction.<sup>6</sup> Moreover, while the Affiliate holds the VRDNs, the interest or other payments the Affiliate would receive, which are initially funded by the Bank under the liquidity arrangement, would be covered transactions by virtue of the attribution rule. The aggregate amount of the covered transactions would be up to [ ]. This amount would cause the Bank to

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<sup>2</sup> 12 U.S.C. § 371c(a)(1) and 12 CFR 223.11 and 223.12.

<sup>3</sup> 12 U.S.C. § 371c(b)(7) and 12 CFR 223.3(h).

<sup>4</sup> 12 U.S.C. § 371c(c) and 12 CFR 223.14.

<sup>5</sup> 12 U.S.C. § 371c(a)(2); 12 CFR 223.16.

<sup>6</sup> The proceeds of the Bank’s loan to the tender agent under the liquidity arrangement are transferred to Affiliate when payments are made to holders of the notes, including Affiliate. As a result, the extension of credit from the Bank to the tender agent would be a covered transaction under the attribution rule to the extent that the proceeds are used to make interest and other payments to Affiliate.

exceed the quantitative limits under the statute and Regulation W as the Bank currently has covered transactions with the Affiliate in an amount of approximately [ ].<sup>7</sup> Accordingly, the Bank is requesting an exemption from the quantitative limits of section 23A and Regulation W in connection with the Proposed Transactions.

Section 23A specifically authorizes the OCC to exempt transactions or relationships from the requirements of the statute if (i) the OCC jointly finds with the Federal Reserve Board such an exemption to be in the public interest and consistent with the purposes of section 23A, (ii) notifies the Federal Deposit Insurance Corporation of the finding, and (iii) the Federal Deposit Insurance Corporation does not object, in writing, to the finding within 60 days.<sup>8</sup> The twin purposes of section 23A are (i) to protect against a depository institution suffering losses in transactions with affiliates; and (ii) to limit the ability of an institution to transfer to its affiliates the subsidy arising from the institution's access to the federal safety net.<sup>9</sup>

The Bank believes that granting the requested exemption would provide public benefits. In particular, the Bank has indicated that permitting the proposed transactions with the Affiliate would provide an efficient means for the Affiliate to help its municipal customers obtain liquidity for VRDNs during this time of strained liquidity caused by COVID-19. A put of the VRDNs would accelerate amortization of the amounts owed and trigger a non-market interest rate which could further strain the resources of municipal entities already adversely affected by COVID-19. Permitting the Bank to purchase the VRDNs from the Affiliate would prevent this additional stress from being added to the municipal entities.

Granting the exemption would not expose the Bank to additional credit or market risk. The Bank is obligated to advance funds under the terms of the liquidity facility agreements regardless of whether the notes are held or tendered by third-party investors or by the Affiliate. If the Bank does not purchase the VRDNs, and they are put by the investors, then remarketing of the VRDNs would cease, and the Bank's exposure to the municipal entity would be transformed into a loan to the issuer, making the Bank's position less liquid and saleable. The Bank represents that the Proposed Transactions would have a negligible impact on the Bank's capital ratios and liquidity coverage ratio.

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<sup>7</sup> For purposes of section 23A and Regulation W, the 10 percent limit for covered transactions with a single affiliate would be approximately [ ].

<sup>8</sup> 12 U.S.C. § 371c(f)(2)(B)(i).

<sup>9</sup> 67 Federal Register 76560 (Dec. 12, 2002).

Moreover, the exemption would be subject to the following limits and conditions that are designed to help ensure that the transactions are consistent with safe and sound banking practices:

- The Bank's purchases of assets permitted by this exemption will be conducted at par.
- The total dollar amount of exempt transactions must be limited to [ ]. The Bank's covered transactions not exempted by this order shall continue to meet the quantitative and other restrictions in section 23A and Regulation W.
- The Bank's purchases of VRDNs must be consistent with safe and sound banking practices and prudent concentration risk management practices.
- The VRDNs purchased by the Bank must be investment grade at the time of purchase as defined in 12 C.F.R. § 1.2(d).
- The Holding Company must agree to repurchase from the Bank, on a quarterly basis, any assets that (i) fail to continue to be externally rated by a nationally recognized statistical rating organization at single-A or better or the credit equivalent thereof or (ii) become low-quality assets (as defined in Regulation W (12 C.F.R. § 223.3(v)) at the price paid by the Bank for the assets plus any accrued but unpaid interest.
- The Bank and the Holding Company are well capitalized, as defined in the OCC's regulations<sup>10</sup> and the Federal Reserve Board's Regulation Y,<sup>11</sup> as applicable, at the time of purchase of any of the VRDNs and would remain well capitalized so long as the Bank continues to hold the VRDNs.
- The exemption is available only for municipal VRDNs acquired by the Bank from the Affiliate between March 25, 2020 and October 25, 2020, due to the ongoing and potential future dislocation in the municipal market caused by COVID-19.
- The Proposed Transactions will continue to be subject to the market terms requirement of section 23B of the Federal Reserve Act.<sup>12</sup>

In light of these considerations, granting the exemption is consistent with the purposes of section 23A and in the public interest. Accordingly, the OCC has informed the Federal Reserve Board of this finding and the Federal Reserve Board has joined the OCC in making this determination. The Federal Deposit Insurance Corporation has been notified and informed the OCC in writing of its non-objection. The OCC hereby grants the requested exemption, subject to the conditions and limits discussed above. This order is specifically conditioned on compliance by the Holding Company and the Bank with all the commitments and representations they made to the OCC in connection with this exemption request. These commitments and representations are deemed to be conditions imposed in writing by the OCC in connection with granting the request and, as such, may be enforced in proceedings under applicable law. This determination is based on the specific facts and circumstances described in your correspondence and this letter. Any material change in those facts or circumstances or any failure by the Bank or Holding Company to

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<sup>10</sup> 12 C.F.R. § 6.4(b)(1)(i).

<sup>11</sup> 12 C.F.R. Part 225.

<sup>12</sup> 12 U.S.C. § 371c-1.

observe any of their commitments or representations may result in a different conclusion or revocation of the exemption findings.

Sincerely,

/s/

Morris R. Morgan  
First Deputy Comptroller