

Potential Implications of Regulation W on National Bank Investments in Community Development Corporations

Executive Summary

Section 23A of the Federal Reserve Act, 12 USC 371c, imposes quantitative, collateral, and other safety and soundness restrictions on certain “covered transactions,” including a bank’s loans to and purchases of assets from affiliates. Section 23B of the Federal Reserve Act, 12 USC 371c-1, generally requires transactions with affiliates to be on “market terms.” The Board of Governors of the Federal Reserve System (Federal Reserve Board) issued Regulation W, 12 CFR 223, implementing sections 23A and 23B of the Federal Reserve Act. National banks and federal savings associations are subject to sections 23A and 23B of the Federal Reserve Act and Regulation W.¹

National banks may make investments in community development corporations (CDC) pursuant to 12 USC 24(Eleventh) and its implementing regulation 12 CFR 24.² Public welfare investment proposals and notices may present issues under sections 23A and 23B of the Federal Reserve Act and Regulation W. This document describes certain examples involving a holding company’s transfer of an interest in its CDC to one or more subsidiary national banks and potential implications under sections 23A and 23B of the Federal Reserve Act and Regulation W.

A. Overview of Section 23A’s Limitations and Restrictions

Section 23A, as implemented by Regulation W, subjects “covered transactions” to limits of 10 percent (single affiliate) and 20 percent (all affiliates) of the bank’s capital stock and surplus. The term “affiliate” includes any company that “controls” the bank and any company under common control with the bank. It generally does not include wholly owned operating subsidiaries of a bank. The term “control” generally means that a bank or other company owns 25 percent or more of a company’s voting securities or equity capital.

Covered transactions include a bank’s purchase of assets from, or investment in securities issued by, an affiliate. A bank “purchases” assets by giving consideration for those assets or by assuming any liabilities in connection with the receipt of such assets. In addition, a bank’s acquisition of the common stock of an affiliated company will be deemed to be a purchase of the affiliate’s assets if, as a result of the acquisition, the company becomes an operating subsidiary of the bank and the bank gives consideration or assumes liabilities.

An investment in securities issued by an affiliate occurs when a bank acquires either an affiliate’s debt or an affiliate’s equity securities, whether or not the bank paid any consideration for them.

¹ 12 USC 371c and 371c-1, 12 USC 1468, and 12 CFR 31.3 and 223.1(c).

² A federal savings association may invest up to the greater of 1 percent of its total capital or \$250,000 in community development investments of the type permitted for a national bank under 12 CFR 24. However, federal savings associations cannot purchase or invest in securities of CDCs that are affiliates as described in this document because of the restrictions contained in 12 USC 1468(a)(1)(B) and 12 CFR 223.72(c)(2) prohibiting savings associations from purchasing securities of any affiliate other than with respect to shares of a subsidiary. Considering this, this document only discusses Regulation W implications for national banks.

Regulation W also contains certain exemptions from some or all of the limitations and restrictions. Under 12 CFR 223.41(b), transactions with a depository institution are exempted from Regulation W's quantitative limits and collateral requirements if the same company controls 80 percent or more of the voting securities of the member bank and the depository institution. This exemption is referred to as the sister-bank exemption.

B. Overview of Section 23B's Market Terms Requirement

Regulation W also provides that "covered transactions," as well as certain other transactions between a national bank and its affiliates, are subject to the market terms requirement of section 23B.³ This means that the transactions must be on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the member bank, as those prevailing at the time for comparable transactions with or involving nonaffiliates, 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, nonaffiliates.⁴ 12 CFR 223.52(a)(1) exempts certain transactions from the market terms requirement, including transactions exempt from section 23A requirements pursuant to the sister-bank exemption.

³ 12 CFR 223.52.

⁴ 12 CFR 223.51. A member bank may not treat an affiliate better than a similarly situated nonaffiliate. Generally, this would not allow a member bank to transact with an affiliate on terms and conditions that it applies to its most creditworthy unaffiliated customer unless the bank can demonstrate that the affiliate is of comparable creditworthiness as the bank's most creditworthy unaffiliated customer. Instead, an affiliate must be treated comparably to a bank's unaffiliated customers engaged in the same business and having comparable credit quality and size as the affiliate.

C. Common Scenarios Pertaining to Bank Investments in CDCs

The following chart breaks down several examples of a holding company's (HC) transfer of an interest in its CDC to one or more of its subsidiary banks:

	Potential Regulation W implications of an HC's transfer of interests in a CDC to the HC's subsidiary bank(s)	Potential status of CDC in relation to bank(s) after transaction
Bank acquires controlling interest in CDC and HC retains less than controlling interest in CDC	<p>12 CFR 223.31 requires a bank's acquisition of a security issued by a company that was an affiliate before the acquisition to be treated as a purchase of assets if (1) as a result of the transaction, the company becomes an operating subsidiary of the bank and (2) the bank gives cash or other consideration or the CDC has liabilities. Then, under 12 CFR 223.31(b), the transaction is valued at the greater of (a) the sum of the total amount of consideration given by the bank and the total liabilities of the CDC or (b) the total value of all covered transactions acquired as a result of the acquisition.</p> <p>If the bank gives no consideration and the CDC has no liabilities, the transaction would be treated as an investment in securities issued by an affiliate under 12 CFR 223.23. The transaction is valued at the greater of (i) the total amount of consideration given including liabilities assumed; or (ii) the carrying value of the security.</p>	<p>The CDC is now an "operating subsidiary" of the bank, and under 12 CFR 223.3(aa) and 12 CFR 223.2(b)(1), an operating subsidiary is generally not considered an affiliate of a bank for purposes of Regulation W. Going forward, transactions between the bank and the CDC are not subject to Regulation W.</p>
Bank acquires controlling interest in CDC and HC retains a controlling interest in CDC	<p>The transaction will be treated as an investment in securities issued by an affiliate under 12 CFR 223.23. The transaction is valued at the greater of (i) the total amount of consideration given including liabilities assumed; or (ii) the carrying value of the security.</p>	<p>Because the CDC is controlled by an affiliate of the bank, under 12 CFR 223.2(b)(1)(iii)(A), it is generally considered an affiliate of the bank for purposes of Regulation W. Going forward, transactions between the bank and the CDC are subject to Regulation W.</p>
Bank acquires less than controlling interest in CDC and HC retains controlling interest in CDC	<p>The transaction will be treated as an investment in securities issued by an affiliate under 12 CFR 223.23. The transaction is valued at the greater of (i) the total amount of consideration given including liabilities assumed; or (ii) the carrying value of the security.</p>	<p>Because the CDC is controlled by a company that controls the bank, under 12 CFR 223.2(a)(2), it is generally considered an affiliate of the bank for purposes of Regulation W. Going forward, transactions between the bank and the CDC are subject to Regulation W.</p>
Multiple affiliated banks each acquire a less than controlling interest and HC retains no interest	<p>The transaction will be treated as an investment in securities issued by an affiliate under 12 CFR 223.23. The transaction is valued at the greater of (i) the total amount of consideration given including liabilities assumed; or (ii) the carrying value of the security.</p>	<p>Because the CDC is indirectly controlled by a company that controls each of the banks (and is not controlled by or a subsidiary of any of the banks) under 12 CFR 223.2(a)(2), it is generally considered an affiliate of each of the banks. Going forward, transactions between each of the banks and the CDC are subject to Regulation W.</p>

In the first example, the holding company transfers to the bank a controlling interest (i.e., greater than or equal to 25 percent) in the CDC and retains a less than controlling interest (i.e., less than 25 percent). If the bank pays consideration or if the CDC has liabilities, then the bank's acquisition of the CDC's stock is deemed to be a purchase of assets. However, if the bank pays no consideration and the CDC has no liabilities, the bank's acquisition of the CDC's stock is an investment in securities issued by an affiliate. In either case, because the bank controls the CDC and because no non-bank affiliate controls the CDC, the CDC is an operating subsidiary of the bank. Going forward, transactions between the bank and the CDC will not be subject to the requirements of Regulation W.

In the second example, the bank again acquires a controlling interest in the CDC. However, in this variation, the holding company retains a controlling interest as well. In this case, the CDC is an affiliate of the bank. Regulation W provides that a company such as the CDC that is controlled both by a bank and by a non-bank affiliate—here, the holding company—is treated as an affiliate of the bank. The bank's acquisition of the CDC's stock is treated as an investment in securities issued by an affiliate. Going forward, transactions between the bank and the CDC will be subject to the requirements of Regulation W.

In the third example, the bank acquires a less than controlling interest in the CDC, with the holding company retaining the remaining interest. The CDC is an affiliate of the bank. The bank's acquisition of the CDC's stock is treated as an investment in securities issued by an affiliate. Going forward, transactions between the bank and the CDC will be subject to the requirements of Regulation W.

In the fourth example, multiple affiliated banks acquire less than controlling interests in the CDC, and the holding company retains no interest. For example, five banks may each acquire 20 percent interest in a CDC. In this case, because the CDC is not controlled by (and therefore is not an operating subsidiary of) any one bank, the CDC is an affiliate of each of the acquiring banks. The banks' acquisition of the CDC's stock are treated as an investment in securities issued by an affiliate. Going forward, transactions between the banks and the CDC will be subject to the requirements of Regulation W.

Questions?

Please contact Bank Advisory at (202) 649-5490 if you have any questions regarding the foregoing.