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Financial Regulatory Reform: Tightening the Regulation of Affiliate Transactions, Extensions of Credit to Insiders, and Lending Limits

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Act) tightens the affiliate transaction rules contained in Sections 23A and 23B of the Federal Reserve Act and the related insider lending rules of Section 22(h) of the Federal Reserve Act, primarily to cover derivative and repurchase transactions entered into with affiliates. The Act also will make it more difficult to obtain exemptions from these rules from the federal bank regulators for specific transactions or groups of transactions. These changes, which are effective one year after the transfer date (which is one year after enactment, unless the Treasury Secretary extends it for up to six months), will affect those entities that have in place derivatives transactions with affiliates. Accordingly, a review of these arrangements may be advisable. However, all institutions covered by these rules will be impacted by the changes in the exemption authority and process.

Affiliate Transaction Rules

Historically, the primary federal statutory provisions governing transactions involving an insured depository institution (including its subsidiaries, collectively referred to as an "institution" below) and its affiliates are Sections 23A and 23B of the Federal Reserve Act, both of which are implemented by Regulation W of the Federal Reserve Board (Federal Reserve). Section 23A defines certain types of transactions as "covered transactions," imposes quantitative limits on an institution's covered transactions with any one affiliate and with all affiliates combined, and requires that certain types of covered transactions of an institution be secured by no less than a certain amount of collateral of specific quality. Section 23B generally requires that certain transactions (which include "covered transactions" and more) involving an institution and its affiliates be on terms and under circumstances that are at least as favorable to the institution as those for comparable transactions with nonaffiliates. By their terms, Sections 23A and 23B apply only to "member banks" (i.e., national banks and state member banks). But Section 18(j)(1) of the Federal Deposit Insurance Act applies these provisions to state nonmember banks,

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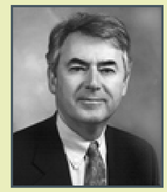

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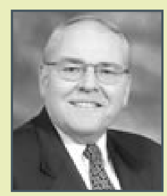

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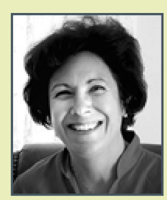

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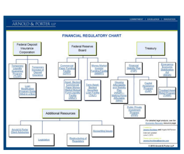

Financial Regulatory Chart

and Section 11(a) of the Home Owners' Loan Act (HOLA) applies them to savings associations.

Section 22(h) of the Federal Reserve Act, which is implemented by Regulation O, imposes certain restrictions, such as quantitative limits and prohibition on preferential terms, on a member bank's extensions of credit to insiders (including executive officers, directors, principal shareholders (other than parent holding companies), and companies and other related interests under their control). Section 22(h) applies to state nonmember banks by virtue of Section 18(j)(2) of the Federal Deposit Insurance Act, and to savings associations by virtue of Section 11(b) of the HOLA.

Under the law as currently in place, the Federal Reserve Board was to adopt final rules by May 12, 2001 to address credit exposure arising from derivative transactions between institutions and their affiliates as covered transactions. To that end, Regulation W, which implements the provisions of Sections 23A and 23B, makes a distinction between credit derivatives and other types of derivatives. Specifically, a credit derivative where an institution agrees to protect a nonaffiliate from a default on, or decline in value of, an obligation of an affiliate of the institution, is considered a guarantee by the institution on behalf of the affiliate, and thus is a covered transaction subject to the quantitative limits and collateral requirements of Section 23A. With respect to other types of derivative transactions (such as an interest rate swap), Regulation W currently only subjects them to the market terms requirements of Section 23B and requires institutions to maintain policies and procedures for managing the related credit exposure. Section 22(h) did not specifically address derivative transactions at all.

The Act amends Sections 23A and 23B in several ways to make them more stringent. First, the Act expands the definition of what is considered an "affiliate." The Act also expands the types of transactions covered by the restrictions of Sections 23A and B, primarily to make sure that all types of derivatives transactions are so covered. Collateral requirements also are strengthened. And finally, the Act restrict the ability of the Federal Reserve to exempt transactions from the restrictions of Sections 23A and 23B.

1. **Definition of Affiliate**. The Act broadens the definition of affiliate to include any investment fund (whether it is a registered investment company or not) for which an institution or any affiliate thereof serves as an investment adviser. As a result, a hedge fund or private equity fund to which an institution or an affiliate of the institution serves as an investment adviser would be an affiliate of the institution.

2. **Covered Transactions**. The Act also broadens the types of transactions covered by the affiliate transaction rules of Section 23A and 23B as follows:

   - An institution's purchase of assets from an affiliate subject to an agreement by the affiliate to repurchase would fall under the "loan or extension of credit" type of covered transaction, which also is subject to the collateral requirements. This likely would affect the types of assets used and the margin required in repurchase transactions between institutions and their affiliates.

   - The Act would clarify that an institution's acceptance of debt obligations issued by an affiliate, even if such obligations are not considered securities, as collateral for an extension of credit to a nonaffiliate would be a covered transaction.

   - A securities lending or borrowing transaction or a derivative transaction with an affiliate would be a covered transaction to the extent that the transaction causes the institution to have credit exposure to the affiliate. Such a covered transaction also would be subject to the collateral requirements. Importantly, the Act clearly eliminates the Federal Reserve's authority to make any distinction between a credit derivatives and other types of derivatives, such as interest rate swaps, because the statutory language itself specifically defines credit exposure arising from derivative transactions with affiliates as a type of covered transaction subject to the quantitative limits and collateral requirements of Section 23A. Of course, issues remain, such as how to quantify the credit exposure arising from a derivative transaction. Presumably, the Federal Reserve would need to issue regulations to resolve these issues.

3. **Collateral Requirements.** The Act tightens the collateral requirements of Section 23A by:

   — Clarifying that debt obligations issued by an affiliate of an institution, even if such obligations are not considered securities, may not be used to meet the collateral requirements for a covered transaction between the institution and any of its affiliates.

   — Providing that the collateral requirements (with respect to both quality and quantity) must be met "at all times," not just "at the time of the transaction." Therefore, if the value of the collateral declines for any reason, additional collateral would need to be provided so that the covered transaction is collateralized in an adequate amount. Under the current statutory language, collateral that is retired or amortized after the time of the transaction must be replaced, but no additional collateral is required if the market value of the collateral posted at the time of the transaction declines to a level lower than that required at the inception of the transaction.

4. **Treatment of Transactions with Financial Subsidiaries.** Under the current statutory language, a financial subsidiary of an institution is treated as an affiliate (whereas other subsidiaries of an institution that are not depository institutions are not so treated), but certain exceptions apply to an institution's covered transactions with a financial subsidiary of the institution. The Act would eliminate these exceptions. As a result, a financial subsidiary of an institution would be treated the same way as any other affiliate. Specifically, there would no longer be an exception that would allow the aggregate amount of covered transactions between an institution and a financial subsidiary of the institution to exceed 10 percent of the institution's capital and surplus, and the retained earnings of the financial subsidiary would no longer be excluded in calculating the institution's investment in securities issued by the financial subsidiary (which is a covered transaction).

   The elimination of these exceptions would appear to have the practical effect of limiting the expansion of any financial subsidiary of an institution. As the retained earnings of a financial subsidiary increases, the value of the parent institution's investment in the financial subsidiary would increase under the amended Section 23A to a level over 10 percent of the parent institution's capital and surplus, unless other business activities of the parent institution also contribute substantially to the growth of its capital and surplus. Therefore, to comply with the 10 percent limit, the financial subsidiary would have to pay out at least some of its net income to the parent institution as dividends instead of reinvesting all of it in the expansion of the financial subsidiary.

5. **Exemptive Authority.** Perhaps one of the most important changes made by the Act is to restrict the ability of the Federal Reserve to issue exemptions from the restrictions of Section 23A. The Act does so in a number of ways:

   — Under the current statutory language, the Federal Reserve may provide for exemptions from Section 23A by regulation or by order. The Act would only allow the Federal Reserve to provide for exemptions by regulation, except that the Federal Reserve could continue to issue exemptive orders with respect to specific transactions of state member banks. In addition, the Act would require the Federal Reserve to provide the Federal Deposit Insurance Corporation (FDIC) with 60 days' notice before issuing any exemptive regulation or order. During the 60-day period, the FDIC could make a written objection to the exemption if it determines that the exemption presents an unacceptable risk to the Deposit Insurance Fund.

   — For certain institutions, the authority to exempt specific transactions from Section 23A by order would be shifted to the Office of the Comptroller of the Currency (OCC), with respect to national banks and federal savings institutions, and the FDIC, with respect to state nonmember banks and state chartered savings institutions. The Federal Reserve's concurrence would be required for any such order issued by the OCC or the FDIC. The same procedures whereby the FDIC could object to the Federal Reserve's exemptive regulations apply to any OCC exemptive order under Section 23A. Furthermore, before the FDIC itself could issue any exemptive order under Section 23A, it would need to find that the order does not present an unacceptable risk to the Deposit Insurance Fund. As a result, the issuance of an exemptive order under Section 23A would in effect require the approval or non-objection of the Federal Reserve and the FDIC, plus the OCC in the case of a federally chartered institution—a much more difficult process.

- The Federal Reserve could issue regulations or interpretations regarding how a netting agreement may be taken into account in determining the amount of a covered transaction. An interpretation on this issue with respect to a specific institution would need to be issued jointly with the institution's primary federal regulator.
- The Federal Reserve could continue to issue exemptive regulations under Section 23B, subject to the same procedures whereby the FDIC could object to the Federal Reserve's exemptive regulations under Section 23A. No agency would have the authority to issue an order to exempt a specific transaction under Section 23B.

Extensions of Credit to Insiders

In addition to the changes made to Sections 23A and 23B, the Act broadens the definition of "extension of credit" in Section 22(h) to include credit exposure that arises from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction. As a result, if a transaction between an insured depository institution and an insider of the institution gives rise to such credit exposure, the institution would need to comply with the restrictions of Section 22(h) with respect to the transaction.

Arnold & Porter provides advice to financial institutions on affiliate transactions. Members of our financial services group have held senior positions at the Federal Reserve and have been involved in interpreting Sections 23A and 23B in that connection. We are available to answer questions raised by these provisions of the Act, and to assist in determining how these provisions may affect your business. For further information, please contact your Arnold & Porter attorney or:

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