September 8, 1995

RE: Applicability of Section 23A of the Federal Reserve Act to Purchases of Mortgages Originated by an Affiliate

Dear [Redacted]

This responds to your letter submitted on behalf of [Redacted] (the "Association"). You request confirmation that the Association's purchases of loans from its affiliate, [Redacted] (the "Mortgage Banker"), comply with the requirements of 12 C.F.R. § 250.250 and are, therefore, exempt from the requirements governing transactions with affiliates under section 23A of the Federal Reserve Act (the "FRA"), and regulations of the Office of Thrift Supervision ("OTS") at 12 C.F.R. § 563.41.

For the reasons discussed more fully below, we conclude that the loan purchase transactions do not comply with 12 C.F.R. § 250.250 and are not exempt from section 23A of the FRA and 12 C.F.R. § 563.41 because the Association's purchases are essentially funding the working capital needs of its affiliate.

I. Background

The Association and the Mortgage Banker are wholly-owned first-tier subsidiaries of [Redacted] (the "Holding Company"). The Holding

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2 The Association and the Mortgage Banker, therefore, are affiliates as defined in section 23A(b)(1)(A) of the FRA and 12 C.F.R. § 563.41(b)(1)(i) (1995) ("affiliate" includes "[a]ny company that controls the savings association and any other company that is controlled by the company that controls the savings association.")
Company acquired the Mortgage Banker in [redacted] to secure a source of high quality single family loans for the Association.

The Association currently purchases virtually all of the Mortgage Banker’s loan production in accordance with the following procedures. The Mortgage Banker’s loan officers procure high quality single family loan applications. Thereafter, the Association’s employees independently evaluate the creditworthiness of each applicant using the Association’s underwriting standards. If the Association’s underwriters approve a loan, the Association commits to purchase the loan from the Mortgage Banker. Following the receipt of the Association’s commitment to purchase, the Mortgage Banker issues a commitment to make the loan to the applicant. Following loan closing, the Association purchases the loan from the Mortgage Banker. Upon purchase, the Association retains some of the loans in its portfolio of assets, and engages the Mortgage Banker as its agent to immediately resell the remainder.

Currently, the Mortgage Banker has no active lines of credit serving as outside sources of funds in support of its mortgage loan production. Prior to entering into the loan purchase arrangement with the Association, the Mortgage Banker had available, and used, substantial lines of credit from other sources to fund its activities.

II. Discussion

Section 11(a) of the Home Owners’ Loan Act applies section 23A of the FRA 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 imposes quantitative restrictions on "covered transactions" with affiliates, including a savings association’s purchase of assets from an affiliate. These restrictions generally limit the aggregate amount of covered transactions with any affiliate to no more than 10% of the capital stock and surplus of the savings association, and limit the aggregate amount of covered transactions involving all affiliates to no more than 20% of the savings association’s capital stock and surplus.

Section 23A also imposes qualitative restrictions on covered transactions with affiliates. These restrictions generally prohibit purchases of low quality assets unless

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certain requirements are met, require covered transactions between a savings association and its affiliates to be on terms that are consistent with safe and sound banking practices, and impose collateral requirements on certain covered transactions.\textsuperscript{7}

A formal interpretive ruling issued by the Federal Reserve Board ("FRB") and codified at 12 C.F.R. § 250.250 contains a narrowly drawn exemption to section 23A where an institution purchases loans (or participation interests in loans) from an affiliate. In this interpretive ruling, the FRB determined that an institution's purchase of a loan, without recourse, from an affiliate is exempt, provided: (1) the institution performs an independent evaluation of the creditworthiness of the proposed borrower(s) before it commits to purchase the loan or participation; and (2) the institution commits itself to purchase the loan or participation prior to the time that the affiliate commits itself to make the loan.

The § 250.250 exemption is not available, however, if the purpose of the loan purchase is to alleviate the working capital needs of the affiliate.\textsuperscript{8} The FRB has concluded that where an institution's purchases of loans from an affiliate provide the sole significant method of funding an affiliate's lending operations, there is a danger that the purchase of the loans may be motivated by a desire to alleviate the working capital needs of the affiliate rather than by the merits of the transactions. Under such circumstances, the FRB has declined to exempt transactions under § 250.250.\textsuperscript{9}

\textsuperscript{7} 12 U.S.C.A. § 371c(a)(3), (a)(4) and (c) (West 1989); see also 12 C.F.R. § 563.41(a)(5), (a)(6), and (c) (1995). Covered transactions are also subject to FRA § 23B, 12 U.S.C.A. § 371c-1 (West 1989), which, \textit{inter alia}, requires transactions to be on arms' length terms.

\textsuperscript{8} See 12 C.F.R. § 250.250(c) (1995) (exemption not available where an institution is impelled by an improper incentive to alleviate the working capital needs of the affiliate that are directly attributable to excessive outstanding commitments); Op. Bd. of Govs. of the Fed. Res. Sys. (May 2, 1990) (a bank's purchase of assets from an affiliate under the exemption may not be used to finance the activities of the affiliate); Op. Bd. of Govs. of the Fed. Res. Sys. (June 18, 1979) (transactions under the exemption may not constitute an arrangement for the bank to provide working capital to the affiliate).

\textsuperscript{9} Op. Bd. of Govs. of the Fed. Res. Sys. (Jan 21, 1988). The FRB has not established a specific limit on the volume or percentage of transactions that would qualify for the exception under 12 C.F.R. § 250.250. However, FRB staff have advised us that, in their view, when an institution buys more than 50% of the affiliate's loan production, the transactions begin to appear to be more of a funding mechanism for the affiliate and less of an investment opportunity for the institution. This percentage, of course, is only one indicia to be considered in assessing whether a transaction operates as a funding mechanism for an affiliate. In certain situations, it is possible that an association's loan purchases could operate as a funding mechanism even though the purchases are less than 50% of the affiliate's loan production. See also OTS Op. Chief Counsel (Apr. 14, 1993) (institution's purchase of greater than 50% of the loans originated by an affiliate fell within § 250.250 exemption where purchases constituted less than 25% of the affiliate's profit from overall annual business.
The circumstances of the transactions between the Association and the Mortgage Banker indicate that the Association is, in essence, the sole significant source of funding for the loan production activities of its affiliate. The Association purchases virtually all of the Mortgage Banker's loan production. Moreover, the Mortgage Banker has no active lines of credit or other established funding sources other than the Association. This dependent relationship is precisely the type of relationship that the FRB has excluded from the § 250.250 exemption.

We conclude, therefore, that the § 250.250 exemption is not available for the loan purchase transactions between the Association and the Mortgage Banker. Accordingly, the transactions are subject to the quantitative and qualitative restrictions of section 23A of the FRA. The OTS Region has advised us that the Association's transactions with the Mortgage Banker currently exceed the quantitative limits. The Region will contact you regarding the steps that should be taken to establish prompt compliance. We defer to the Region to determine what supervisory or enforcement measures, if any, should be taken against the Association for violating the quantitative limits.

We note that there are ways that the Association and the Mortgage Banker could restructure their relationship that would allow the Association to continue purchasing all or substantially all of the Mortgage Banker's loans, provided the Region has no supervisory objections. For example, loan purchases of the Association from the Mortgage Banker would not be subject to transactions with affiliates restrictions if the Mortgage Banker were to become a subsidiary of the Association, provided the subsidiary qualified for the exemption for subsidiaries from the definition of "affiliate" set forth in OTS regulations.\(^\text{10}\)

We also note that once the Association sells a purchased loan, the amount of the loan purchase is deducted from the aggregate amount of covered transactions subject to the quantitative limitations of section 23A of the FRA.\(^\text{11}\) Accordingly, if the Association were to resell loans purchased from the Mortgage Banker, rather than holding them in portfolio, it could, if the purchases and sales were timed properly, income.)

We also note that FRB staff have indicated that the § 250.250 exception may not be available where a substantial percentage of an institution's capital is invested in loans held in portfolio that were originated by an affiliate, since the concentration of risk could raise safety and soundness concerns.


potentially purchase the Mortgage Banker's entire loan production without violating the quantitative limitations. This type of arrangement would not raise the same supervisory concerns as described above because the Association would not be accumulating large quantities of loans on its books originated by the Mortgage Banker. Of course, the Association must execute its purchases and sales with great care since any violation of the quantitative limitations will subject the Association to appropriate supervisory or enforcement actions. Additionally, this arrangement could be subject to criticism if the loans were sold with recourse, if the Association passed up better business opportunities in order to continue purchasing and reselling loans from the Mortgage Banker, or if the arrangement was otherwise detrimental to the Association.

In reaching the conclusions expressed herein, we have relied on the factual representations made in the materials you submitted and in subsequent discussions with the OTS Regional Office, as summarized herein. Our conclusions depend on the accuracy and completeness of those representations. Any material difference in facts or circumstances from those described herein could result in different conclusions.

If you have any questions regarding this matter, please feel free to contact Karen Osterloh, Counsel (Banking and Finance) at (202) 906-6639.

Very truly yours,

Carolyn J. Buck
Chief Counsel

cc: All Regional Directors
    All Regional Counsel