



Regulation W Special Analysis: Impact on National Bank Community Development Corporations

Executive Summary

Section 23A of the Federal Reserve Act imposes quantitative, collateral and safety and soundness restrictions on certain “covered transactions” such as a bank’s loans to, and purchases of assets from affiliates. Section 23B generally requires transactions with affiliates to be on “market terms.” The Federal Reserve Board’s (“FRB”) Regulation W, effective on April 1, 2003, implements and interprets these statutes.

National banks may make investments in community development corporations (“CDCs”) pursuant to 12 USC § 24(Eleventh) and its implementing regulation 12 C.F.R. part 24. Public welfare investment proposals and notices may present issues under sections 23A and 23B of the Federal Reserve Act. One scenario involves a holding company’s transfer of an interest in its CDC to one or more subsidiary banks. Regulation W’s treatment of both this transfer and any subsequent transactions between the bank(s) and the CDC turns on who controls the CDC.

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

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 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 whenever a bank acquires either an affiliate’s debt or an affiliate’s equity securities, whether or not the bank paid any consideration for them.

Regulation W also contains certain exemptions from some or all of the limitations and restrictions. Important among these is the so-called “sister-bank” exemption, which allows a bank to transact with an insured affiliated bank or an insured affiliated bank’s operating subsidiary, without regard to any limitations or restrictions except the safety and soundness requirement and the prohibition against a bank’s purchase of low-quality assets. The regulation also includes a new, though limited, exemption for certain internal corporate reorganizations and recodifies the FRB’s existing exemption for mergers between banks and affiliated insured banks that are subject to the Bank Merger Act (“BMA”).

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. 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.¹ The regulation exempts some transactions from section 23B’s market terms requirement, including transactions exempt from section 23A pursuant to the sister-bank and BMA exemptions.

C. Common Scenario Pertaining to Bank Investments in CDCs

The following chart breaks down several variations of a holding company’s transfer of an interest in its CDC to one or more subsidiary banks:

¹ 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, the affiliate must be treated comparably to the majority of unaffiliated customers engaged in the same business and having comparable credit quality and size, as the affiliate.

	How does Regulation W treat the acquisition of the CDC by the Bank(s)?	After acquisition, what is the status of the CDC with respect to the Bank(s)?
Bank acquires controlling interest in CDC and holding company retains <i>less than controlling</i> interest in CDC	<p>Purchase of assets, if the Bank gives consideration or the CDC has liabilities, transaction valued at the greater of (i) the sum of the total amount of consideration given and the total liabilities of the CDC or (ii) the total value of all covered transactions acquired as a result of the security acquisition.</p> <p>Investment in securities issued by an affiliate, if the Bank gives no consideration and the CDC has no liabilities, transaction valued at the greater of (i) the total amount of consideration given including liabilities assumed; or (ii) the carrying value of the security.</p>	CDC is an “operating subsidiary” of the Bank. Going forward, Regulation W does not apply to transactions between the Bank and the CDC.
Bank acquires controlling interest in CDC and holding company retains a <i>controlling</i> interest in CDC	Investment in securities issued by an affiliate, transaction valued at the greater of (i) the total amount of consideration given including liabilities assumed; or (ii) the carrying value of the security.	CDC is an affiliate of the Bank. Going forward, transactions between the Bank and the CDC are subject to Regulation W.
Bank acquires less than controlling interest in CDC and holding company retains <i>controlling</i> interest in CDC	Investment in securities issued by an affiliate, transaction valued at the greater of (i) the total amount of consideration given including liabilities assumed; or (ii) the carrying value of the security.	CDC is an affiliate of the Bank. Going forward, transactions between the Bank and the CDC are subject to Regulation W.
Multiple affiliated banks each acquire a less than controlling interest and holding company retains no interest	Investment in securities issued by an affiliate, transaction valued at the greater of (i) the total amount of consideration given including liabilities assumed; or (ii) the carrying value of the security.	CDC is an affiliate of each of the Bank. Going forward, transactions between each of the Banks and the CDC are subject to Regulation W.

In the first variation, the holding company transfers to the bank a controlling interest (e.g., ≥ 25 percent) in the CDC and retains a less than controlling interest (e.g., < 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 scenario, 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 variation, 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 scenario, 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 Activities & Structure, at (202) 649-5500 if you have any questions regarding the foregoing or how it may apply to federal savings associations.

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