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Consider these guidelines when conducting affiliate transactions

By Leanne R. Kelly

The Federal Reserve expects a bank holding company to act as a source of strength to its insured depository institutions.

To act as a source of strength, holding companies must ensure that transactions between the depository institutions and its affiliates are conducted in a manner that places the interests of the depository institution equal to or above those of the affiliate. These requirements are set forth in sections 23A (Relations with Affiliates) and 23B (Restrictions on Transactions with Affiliates) of the Federal Reserve Act and the Board of Governors Regulation W (Transactions between Member Banks and Their Affiliates). In their simplest terms, these regulations require that transactions between a bank and its affiliates must be at terms and conditions no less favorable to the bank than the bank would receive if the transaction were an arm's length transaction among nonaffiliated entities. Keeping this one principle in mind will greatly assist bankers navigate the complexities of these regulations successfully.

Areas of the regulations where we see periodic compliance issues involve understanding the wide breadth of transactions that are subject to the regulations. Essentially the regulations cover any transaction involving something of value leaving the bank and going to its holding company, to any of its nonbank subsidiaries, to another company under common ownership or control, or to any third party where the proceeds of the transaction are used for the benefit of or transferred to any of these related parties. The item of value may be cash, property or other assets, or services, which are transferred now or in the future. For example, a future transfer of value would occur when a holding company donates a nonbank subsidiary and its related debt to its subsidiary bank. The item of value leaving the bank is the money it will pay on the debt in the future.

Understanding which companies are affiliates of the subsidiary bank is an important consideration to help ensure compliance with the regulations and complete reporting. In general, section 23A defines companies that control or are under common control with the bank to be affiliates of the bank. Control, in this case, is generally considered to be owning 25 percent or more of the voting power or stock. A holding company wholly owning a bank is an affiliate of that bank. An example of common control would be if two people owned a combined 25 percent of the holding company and a combined 25 percent of a furniture store. The holding company and the furniture store would both be affiliates of that bank.

Once you have identified an affiliate transaction, then you can determine whether the transaction is restricted or limited under the regulations. Banks are prohibited from engaging in certain specified transactions ("covered transactions") with an affiliate unless the aggregate amount of such transactions with that particular affiliate is less than 10 percent of the bank's capital stock and surplus. In addition, the aggregate amount of all covered transactions between a bank and all its affiliates is limited to 20 percent.

Last but not least, you want to ensure that all transactions are conducted on terms and conditions that are consistent with safe and sound banking practices. This includes the requirements that a bank may not purchase a low-quality asset from its affiliates and that the transaction must meet prescribed collateral requirements for credit transactions originated by the bank for an affiliate. Finally, transactions between a bank and its affiliates must be on terms and under circumstances, including credit standards, that are substantially the same as or at least as favorable to the bank as those prevailing at the time for comparable transactions with or involving nonaffiliated entities.

Not every holding company director and executive officer needs to be an expert on sections 23A and 23B or Regulation W. To effectively manage the potential landmines, management should take a few key steps. First, be aware of whom the subsidiary bank's affiliates are and the level and type of likely affiliate transactions. Make a list of the affiliates and update it regularly. Second, monitor the affiliate transactions being conducted. Third, have a method for administering affiliate transactions and reporting them to the board and your Federal Reserve Bank. Finally, for directors, be inquisitive about affiliate transactions, ensure that management has developed a system to identify and monitor such transactions, and otherwise monitor affiliate activities.

If you are unsure whether a transaction is covered under Regulation W, we encourage you to reach out to safety and soundness staff at your local Federal Reserve Bank for additional information.

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