DEFINITIONS AND AUTHORITIES

Sections 23A and 23B of the Federal Reserve Act (FR Act), as applied by the Federal banking agencies under various Federal banking statutes, govern transactions between banks and affiliated business organizations. The Gramm-Leach-Bliley Act (GLBA) amended many laws governing the affiliation of banks and other financial service providers. Among other laws, the GLBA amended the Banking Act of 1933, the Bank Holding Company Act of 1956, (BHC Act), the Interstate Banking and Branching Efficiency Act of 1994, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, the International Banking Act of 1978, the FR Act, the Federal Deposit Insurance Act (FDI Act), and the Home Owners' Loan Act.

Section 18(j) of the FDI Act extends the provisions of Sections 23A and 23B of the FR Act to state nonmember banks. Section 23A regulates transactions between a bank and its "affiliates," as that term is specifically defined in Section 23A. Section 23B of the FR Act was enacted as part of the Competitive Equality Banking Act of 1987 to expand the range of restrictions on transactions with affiliates. Section 10(b)(4) of the FDI Act authorizes FDIC examiners in the course of examining insured banks "to make such examinations of the affairs of any affiliate of any depository institution as may be necessary to disclose fully --- (i) the relationship between such depository institution and any such affiliate; and (ii) the effect of such relationship on the depository institution." "Affiliate" is defined in Section 3(w)(6) of the FDI Act as having the same meaning as the definition of that term in Section 2(k) of the BHC Act.

FDIC's enforcement authority also extends to certain parents and affiliates which are not bank holding companies. Section 3(u) of the FDI Act defines "institution affiliated parties" to include the controlling stockholder of an insured depository institution, or any shareholder or person who participates in the conduct of the affairs of an insured depository institution, or any independent contractor who participates in certain acts which cause significant adverse affect on an insured depository institution. This would include the parent companies of Industrial Loan Companies and other "non-bank" charters. Under Section 8(b) of the FDI Act, the FDIC can issue Orders against institution affiliated parties.

This section of the Manual discusses affiliates and subsidiaries, including the restrictions on transactions between affiliates and insured banks, exceptions to those restrictions, and the examination authority of the FDIC with respect to affiliates of nonmember insured banks. It also discusses the major provisions of the GLBA as affecting such transactions and the statutory implications for the FDIC examination process.

GRAMM-LEACH-BLILEY ACT (GLBA)

The passage of the GLBA significantly expanded the powers of bank subsidiaries of bank holding companies to engage in "financial activities," including offering insurance and securities products. The GLBA added Section 46 of the FDI Act that prescribes the circumstances in which an insured state bank may engage in financial activities as principal that may be conducted by a national bank only through a financial subsidiary. The GLBA also repealed the restrictions on banks affiliating with securities firms which were contained in Section 20 of the Glass-Steagall Act and repealed the prohibition on interlocking directors between banks and securities firms contained in Section 32.

Financial Holding Company

The GLBA authorizes the organization of a "financial holding company" (FHC) under Section 4 of the BHC Act. A FHC can engage in any activity, and may acquire shares of any company engaged in any activity, that the Board of Governors of the Federal Reserve System (the FRB) determines to be either financial in nature or incidental to such financial activity, or complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

The GLBA identifies some specific activities which are determined to meet this test and prescribes a consultative process involving the shared input of both the FRB and the Secretary of the Treasury for future definition of activities determined to meet the test.

Section 4(k)(4) of the BHC Act identifies a list of specific activities deemed "financial in nature" for these purposes. Qualifying FHCs may engage in such activities without regulatory approval provided notice is given to the FRB within 30 days after the activity is commenced. The listed activities include:

- Lending, exchanging, transferring, investing for others, or safeguarding money or securities,
- Insuring, guaranteeing or indemnifying against loss or illness, or issuing or providing annuities, as principal, agent or broker,

- Providing various forms of financial, investment or economic advisory services, including advising investment companies,
- Issuing and selling instruments representing interests in pools of assets permissible for a bank to hold directly,
- Securities underwriting, dealing and market making,
- Engaging in activities that have been determined to meet the "closely related" and "proper incident" tests under Section 4(c)(8) of the BHC Act,
- Engaging in activities in the United States that the FRB has previously authorized bank holding companies and their subsidiaries to conduct abroad under Section 4(c)(13) of the BHC Act,
- Certain merchant banking activities, and
- Certain "insurance company portfolio investment" activities.

Conditions Precedent to New Activities:

The following guidelines exist relative to a bank holding company entering into new activities:

- All depository institution subsidiaries of the bank holding company must be "well capitalized" and "well managed."
- A "satisfactory" or better CRA rating must have been received by all of the depository institution subsidiaries at their most recent examination.
- The bank holding company must file with the FRB an election to become a financial holding company.
- There is a grandfather provision for certain non-conforming activities of a company that is not now a bank holding company but then becomes one to continue to engage in commercial activities in an amount not to exceed 15 percent of its consolidated annual gross revenues, excluding bank subsidiaries. The grandfather provision will expire ten years after the date of enactment, unless extended by the FRB for an additional five years.

The FRB is the umbrella supervisor for FHC's. As such, the FRB assesses the FHC's overall financial condition and the systems for monitoring risks for the entity as a whole.

Financial Subsidiaries

Implementing Section 121 of the GLBA as it pertains to state nonmember banks, the FDIC added Subpart E to Part 362 of its regulations. For purposes of Subpart E, a "financial subsidiary" is defined as a subsidiary that is controlled by a state nonmember bank and engages as principal in activities which may be conducted by a national bank only through a financial subsidiary. Most activities that were identified in the GLBA as being financial in nature are already permissible for a national bank to conduct directly.

The statutory criteria that must be satisfied in order to engage in activities through a financial subsidiary are:

- The state nonmember bank and each insured depository institution affiliate of the state nonmember bank must be and continue to be well capitalized after deducting the bank's investment, including retained earnings, in all financial subsidiaries.
- The state nonmember bank must disclose the capital deduction and the separate assets and liabilities of the subsidiary in any published financial statement.
- The state nonmember bank must comply with the ongoing financial and operational safeguards required by Section 5136A(d) of the Revised Statures of the United States, which requires operational safeguards to separate the bank from the risks of the subsidiary.
- The state nonmember bank must comply with the amendments to Sections 23A and 23B of the FR Act made applicable by Section 121(b) of the GLBA that require certain ongoing transactional restrictions.
- The state nonmember bank and all of its insured depository affiliates must have received a CRA rating of not less than a "satisfactory record of meeting community credit needs" in its most recent CRA examination.

Functional Regulation

The GLBA also provides for the functional regulation of securities and insurance activities. This means that similar activities should be regulated by the same regulator so as to promote regulatory efficiencies and eliminate burden and duplication. Accordingly, banking activities are to be regulated by bank regulators, securities activities by securities regulators and insurance activities by State insurance departments. In order for functional regulation to be effective, certain consultation and information-sharing requirements are also contained in the statute.

The BHC Act was amended to restrict the authority of the FRB to require reports, conduct examinations, impose capital requirements or take any other direct or indirect action with respect to any functionally regulated affiliate of a depository institution. Section 45 was added to the FDI Act, which made these restrictions applicable to the FDIC.

It is still necessary to determine the significance of the activities conducted by the functionally regulated subsidiaries and determine whether the level of such activities could pose a material risk to the insured depository institution. This functional regulation concept does not, however, alter the Corporation's authority under Section 10(b)(4) of the FDI Act to examine affiliates "as may be necessary to disclose fully (i) the relationship between the depository institution and the affiliate; and (ii) the effect of such relationship on the depository institution."

A functionally regulated entity under the GLBA means a company:

- Engaged in insurance activities (as agent or principal) supervised by State insurance commissioners;
- Registered with the Securities and Exchange Commission (SEC) as an investment company under the Investment Company Act of 1940;
- Registered as an investment adviser either with the SEC or any State; or
- Engaged in commodity activities regulated by the Commodities Futures Trading Commission.

EXAMINATION AUTHORITY

The authority of examiners to examine all affiliates of State nonmember banks is contained in Section 10(b) and 10(c) of the FDI Act. In exercising the authority to examine State nonmember insured banks and their affiliates, examiners are empowered by Section 10(b) to make a thorough examination of all of the affairs of the bank and its affiliates and are directed to make a full and detailed report of condition of the bank to the FDIC. The authority to examine affiliates extends to those entities set forth in Section 23A of the FR Act.

The manner in which such examinations are conducted, and the format of the reporting on their condition, are not specified by either regulation or specific policy guidance. This is the case for two reasons. First, the type of affiliate and the nature of transactions with the insured institution can vary significantly; requiring sometimes more or less review, and typically a far different type of analysis than would be conducted for financial institution affiliates. Second, the risk presented by the activities of affiliates to the insurance fund is likely to be indirect, especially for those not engaged in direct transactions with the insured institution. Examinations under the FDIC's 10(b) authority will need to be tailored to the level of risk to which the insured institution is exposed as a result of transactions between, and the operations of, the relevant affiliates.

In addition, Section 10(c) of the FDI Act empowers the FDIC to issue, in the course of an examination, subpoenas and to take and preserve testimony under oath related to any matter in respect to the affairs or ownership of any such institution or affiliate. Accordingly, individuals, corporations, partnerships, or other entities which in any way affect the bank's affairs or ownership may be subpoenaed and required to produce documents under the FDIC's Section 10(c) powers.

Proper use of Section 10(c) powers can be a valuable aid to the FDIC in carrying out its supervisory responsibilities. However, the reasons why examinations of affiliates are considered advisable or necessary by the examiner should be documented, and the extent of any such examination should have prior clearance from the Regional Office. The exercise of Section 10(c) powers will require extensive legal documentation and should only be initiated following authorization from the Director, DSC.

BANK HOLDING COMPANIES

Under Section 2 of the BHC Act a "bank holding company" is defined to include any corporation, partnership, business trust, association, or similar organizations, or any long-term trust (one which extends beyond 25 years or 21 years and 10 months after the death of individuals living on the effective date of the trust) which has control over any bank or over any bank holding company. A bank, of course, is a company and, therefore, may be a bank holding company if it controls another bank or bank holding company. By virtue of amendments to the BHC Act, one-bank holding companies, partnerships, and under certain circumstances, bank trust departments are within BHC Act limits. An existing BHC may become an FHC by notifying the FRB of its election to do so. The BHC must certify that each of the FHC's insured depository institution subsidiaries is well capitalized and well managed.

Definition of Control

Under the BHC Act, a company has control over a bank or any other company (1) if it directly or indirectly owns, controls, or has the power to vote 25 percent or more of any class of voting securities of such bank or other company, (2) if it controls, in any manner, the election of a majority of the directors of such bank or other company, or (3) the FRB determines, after notice and hearing, that the company exercises a controlling influence over the management or policies of the bank or company. Shares owned or controlled by any subsidiary of a bank holding company are considered to be indirectly owned or controlled by the holding company. Shares held or controlled directly or indirectly by trustees for the benefit of a company or the shareholders or employees of a company are deemed to be controlled by the company. Refer to FRB Regulation Y, Section 225.2 for further clarification.

There is also a rebuttable presumption of control if the FRB, as authorized, finds that a company directly or indirectly exercises a controlling influence over the management or policies of the bank or bank holding company. In order to establish guidelines implementing these sections of the BHC Act, the FRB has adopted the following presumptions of control that may be rebutted by the affected company:

1. A company that owns, controls, or has power to vote more than 5 percent of the voting securities of a bank or bank holding company if; one or more of the company's directors, trustees or partners, or officers or employees with policy-making functions, serves in any of these capacities with the bank or holding company, and no other person owns, controls or has power to vote as much as 5 percent of any class of voting securities of the bank or bank holding company.
2. A company that owns, controls or has power to vote more than 5 percent of any class of voting securities of a bank or bank holding company if; additional voting securities are owned, controlled or held with power to vote by individuals or members of their immediate families (spouse, children, grandchildren, parents or their ancestors, stepchildren or stepparents, all whether natural or adopted) who are directors, officers, trustees or partners of the company (or own directly or indirectly 25 percent or more of any class of voting securities of the company) and such holdings together with the company's holdings aggregate 25 percent or more of any class of voting securities of the bank or bank holding company. The presumption does not apply under (1) and (2) where securities are held in a fiduciary capacity and the company does not have sole discretionary authority to exercise the voting rights.
3. A company that enters into any agreement or understanding with a bank or bank holding company (other than an investment advisory agreement), such as a management contract, pursuant to which the company or any of its subsidiaries exercises significant influence with respect to the general management or overall operations of the bank or bank holding company presumably controls such bank or bank holding company.
4. A company that enters into an agreement or understanding under which the rights of a holder of voting securities of a bank or other company are restricted in any manner, presumably controls the shares involved unless the agreement; is a mutual agreement among shareholders granting each other a right of first refusal with respect to their shares, is incident to a bona fide loan transaction, or relates to restrictions on transferability and continues only for such time as may reasonably be necessary to obtain from a Federal bank supervisory authority with respect to acquisition by the company of such securities.
5. A company that directly or indirectly owns securities that are convertible immediately at the option of the holder or owner into voting securities, presumably owns or controls the voting securities.

In addition to the foregoing, the FRB may, under its regulations, administratively determine that a company controls a bank or other company. Congress has apparently established 5 percent as the benchmark for determining whether or not “control" exists and the FRB has to a great extent incorporated that benchmark into its regulations dealing with the rebuttable presumption of control. Accordingly, under the BHC Act, there is a presumption that a company does not have control over a bank or other company if the company directly or indirectly owns, controls, or has the power to vote less than 5 percent of the voting securities of such bank or other company. Furthermore, a company does not have control of a bank or other company unless at the time in question that company directly or indirectly owned, controlled, or had power to vote 5 percent% or more of the voting securities of a bank or other company, or had already been found to have control by the FRB after notice and opportunity for hearing.

PARENT COMPANIES WHICH ARE NOT BANK HOLDING COMPANIES

The primary forms of insured bank whose parent company does not fall under the definition of Bank Holding Company (BHC) or Financial Institution Holding Company for the purposes of the Bank Holding Company Act (BHCA), are the Industrial Loan Company (ILC) and the Savings Bank. Both of these insured entities are otherwise defined as banks under Section 3 of the FDI Act.

ILCs are defined for the purposes of the BHCA exemption, Section 2c(2)(H), as “… an institution … which does not accept demand deposits … ; which has total assets of less than $100 million … or ; which is not acquired by any company after the … enactment of the Competitive Equality Amendments of 1987; or is an institution which does not … engage in any activity in which it was not lawfully engaged as of March 5, 1987 …” Savings Banks are defined in Section 3g of the FDI Act, and are essentially State Savings Banks.

The Competitive Equality Banking Act (CEBA) of 1987, in redefining a bank as any bank insured by the FDIC and eliminating the loophole in the BHCA for institutions that accepted demand deposits or made commercial loans but not both, also created a small group of grandfathered institutions. These "CEBA" banks are also known as "non-bank banks," have the same activity restrictions as do ILCs, and their parent companies would also not necessarily have to be Bank Holding Companies. The growth in the "non-bank bank" charter, entities sometimes called limited charter institutions, is now primarily in ILCs.

While some limited charter institutions are owned by bank holding companies, most are owned by parent companies whose limited activities and primary purpose of owning the insured institution, make these parents virtually identical to the shell bank holding company. However, ILCs can be owned by commercial parent companies. Some of these corporations are otherwise engaged in a diversity of business activities which would otherwise preclude them from owning a bank and being a bank holding company. These commercial corporations presently include some of the largest manufacturing, insurance, retail, and investment banking firms.

For more specific information regarding the various definitions, limitations, and restrictions on non-bank financial institutions, see the relevant provisions of the BHC Act, 12 U.S.C. 1843(f)(3) and Regulation Y, 12 C.F.R. 225.2 and 225.52. These are included under the Bank Holding Company Act tab in the Prentice-Hall volumes.

CEBA Credit Card Banks

CEBA credit card banks are also exempt from the BHC Act and may be owned by commercial entities. Their operations are restricted to only issuing credit cards, accepting no demand deposits, accepting only jumbo deposits ($100,000 minimum), having only one office, and not making any commercial loans.

Unitary Thrift Holding Companies

Prior to the enactment of the GLBA, any company, regardless of its activities, could acquire a single savings association if the prospective subsidiary satisfied the qualified thrift lender test (QTL).[1]

The advantages of that charter included preferential taxation, liberal branching rights, expanded subsidiary powers and virtually unlimited holding company activities. Many of the thrifts with this charter were owned by commercial entities.

The GLBA prohibits the creation of new unitary thrift holding companies that engage in commercial or other nonfinancial activities. The GLBA did, however, grandfather most unitary thrift holding companies in existence as of May 4, 1999.

Industrial Loan Companies

Industrial Loan Companies (ILCs), also known as industrial banks, are state-chartered banking institutions. While only permissible in a limited number of states, they generally have broad banking powers, and under certain circumstances ILCs may be owned by commercial entities. Specifically, an ILC that meets certain criteria is not a "bank" under the BHC Act, and any company that controls such an ILC would not be subject to FRB regulation and supervision as a bank holding company.[2] Most ILCs have Federal deposit insurance (made available under the Garn-St. Germain Depository Institutions Act of 1982 legislation) and are regulated in a similar manner to state-chartered commercial banks.

Core ILC functions are traditional financial activities that can commonly be engaged in by institutions of all charter types. An ILC can:

- offer a full range of deposits, except demand deposits (unless grandfathered);
- offer a full range of loans and other financial services to both consumer and commercial customers;
- be an original issuer of Visa or Master Card credit and debit cards;
- fund its operations with deposits and Federal Home Loan Bank (FHLB) borrowings.

If an ILC is organized as a limited purpose or credit card institution, then its products and services would be limited to specified activities.

The GLBA did not repeal the ILC exception contained in the BHC Act. As such, commercial firms may continue, as State law permits, to acquire and control ILCs without complying with the BHCA so long as the ILCs satisfy the criteria for the exception. In the case of a parent subject to the reporting requirements of another regulatory body covered under the GLBA, such as the SEC or a State insurance commissioner, the FDIC has agreements in place to share information with such functional regulators. In examining any insured depository institution, the FDIC has the authority (under 12 U.S.C. § 1820(b)(4)) to examine any affiliate of the institution, including its parent company, as may be necessary to determine the relationship between the institution and the affiliate and to determine the effect of such relationship on the institution.

Unique Characteristics of Commercial Parent Companies

Certain bank charters, such as ILCs, may have commercial parent companies in place of a traditional bank holding company or financial institution holding company. As with bank holding companies, these commercial parents can be a source of strength for their subsidiary bank by providing access to the capital and debt markets, and affording the opportunity to use a variety of technical services not always available to small or mid-size banks.

However, commercial parents also present different management challenges to the insured institution and different analytical challenges to examiners. Commercial parents may not be able to offer additional management expertise directly relevant to financial institutions. In serving the specific financial needs of a commercial company, a niche bank may be insufficiently diversified against credit or liquidity risks. Further a financial catastrophe at a parent or affiliate, unrelated to the business of the insured institution, could result in an unanticipated but immediate disruption to the earnings or operations of the insured entity.

Moreover, assessment of “extra-insured” risk factors cannot be made with the comparatively straight-forward ratio analysis used for evaluating bank holding companies. Commercial firms present more varied revenue streams and business risks. Further, while a clearly identified weakness in the insured institution will generally determine the need to conduct an assessment of the potential source of strength provided by the commercial parent, any determination of a “potential source of weakness” presented by a parent or affiliate to an otherwise healthy insured entity will be far more complex. Examiners should only undertake such an assessment following consultation and direction from the Regional Office.

For non-bank holding companies or commercial parent entities, some possible sources for financial analysis include: parent entity quarterly or annual reports, Securities and Exchange Commission filings such as 10-Ks, 10-Qs, etc., bank records on affiliates, external industry analysis sources (i.e. Moody’s Standard and Poor’s, etc.), internal and/or external audits, corporate press releases, newspaper articles, etc.

HOLDING COMPANY EFFECT ON SUBSIDIARY BANKS

A sound, well-managed holding company can be a source of strength for unit banks; however, if the condition of the holding company or its nonbank subsidiaries is unsound, the operation of subsidiary banks can be adversely affected.

Management

The long-term health of an institution depends on a strong, independent and attentive board. The board sets the overall tone and direction of the institution and establishes policies and procedures concerning the nature and amount of risk the institution may take.

Solid corporate governance principles recognize the following elements necessary for the successful operation of the depository affiliated institution:

Each member of the board of directors should have the skills, integrity, knowledge, and experience necessary to allow the director to fulfill his or her responsibilities to the insured institution. The qualifications should be considered in light of the institution’s size, complexity and risk profile. Board membership should be considered not only on an individual basis, but also collectively such that the composition provides a well rounded set of skills, knowledge, and experience.

The board of directors is responsible for actively overseeing the affairs of the institutions. This oversight should include:

- Reviewing and approving major corporate actions and the institution’s overall corporate strategies, business plans, performance objectives, risk policies and risk tolerances,
- Monitoring the institution’s adherence to the strategies, plans, objectives, risk policies and risk tolerances approved by the board, including policies and standards relating to conflicts of interest management,
- Reviewing appropriate regulatory and audit reports, and
- Taking appropriate action with respect to all matters requiring board attention.

The board of directors is responsible for ensuring that the institution, its directors, management, principal shareholders, and affiliates avoid potential direct and indirect conflicts of interest and comply with Federal laws and regulations that are designed to prevent misuse of depositors’ funds.

The board of directors is responsible for hiring and retaining executive officers with the skills, integrity, knowledge and expertise appropriate to the nature and scope of their responsibilities. Executive officers must have the ability to manage day-to-day operations to achieve the institution's performance goals. They should also possess the industry expertise to assess the institution's current performance and condition and to help the board plan for the institution's future.

The board of directors is responsible for establishing and maintaining appropriate committees, and that written charters delineating each committee's functions, responsibilities and membership qualifications have been adopted by the full board.

The board of directors is responsible for ensuring that the insured depository institution maintains a separate corporate existence from its affiliates. This separateness also pertains to the sound tenet that all financial and other pertinent records for the financial institution affiliate be accessible on location.

Financial Considerations

The holding company structure can provide its subsidiary bank strong financial support because of greater ability to attract and shift funds from excess capital areas to capital deficient areas. The financial support can take the form of equity capital injections and/or the funding of loans and investments. However, when the financial condition of the holding company or its nonbanking subsidiaries is tenuous, pressures can be exerted on the subsidiary banks. In order to service its debt or provide support to another nonbank subsidiary, the holding company may place inordinate financial pressure on its subsidiary banks by any of the following methods: payment of excessive dividends; pressure subsidiary banks to invest in high risk assets to increase asset yields; purchase and/or trade its high quality assets for the other affiliate's lower quality assets; purchase of unnecessary services from affiliates; or payment of excessive management or other fees.

Although no formal policy statement has been issued by the FDIC, it has long been the FDIC's position that management and other fees paid by subsidiary banks should have a direct relationship to the value of actual goods or services rendered based on reasonable costs consistent with current market values for such services. Bank files should contain adequate information to permit a determination as to what goods and services are being provided and on what basis they are being priced. Charges should not be based on resources, deposits, or earnings of the bank. In those instances when payments are large and are not or could not be justified on the basis of services received by the bank, a comment should be included in the Report of Examination.

An additional method of upstreaming funds from a bank to its parent is through the remittance of income taxes to the parent that then files a consolidated income tax return. Due to timing differences arising from the use of different accounting methods for Reports of Condition and Income (Call Reports) and for income tax purposes, a portion of taxes reflected in Reports of Income and Condition will be deferred; however, in certain instances, banks are required to remit to the holding company the entire amount of income tax expense, both current and deferred. The FDIC's Statement of Policy Income Tax Remittance by Banks to Holding Company Affiliates, indicates past transfers of this kind shall be restated on the bank's books and future tax transfers shall only include the current portion of income tax expense.

Even when the holding company is financially sound, supervisory concerns may arise as the parent issues long-term debt to fund equity capital in the subsidiaries. Although this capital raising activity, known as "double leveraging," does increase equity capital in the subsidiary, too much debt at the holding company level can generate pressure on the subsidiary to upstream additional dividends. Since the holding company often services the debt with dividends from the lead bank, holding company debt service requirements which come to exceed historical dividend payment ratios may place undue earnings pressure on the bank. Should dividends be insufficient, the holding company may attempt to create other means of generating cash, such as charging the subsidiary for management and operating expenses.

The double leverage ratio is the equity of the subsidiary, or in the case of multiple subsidiaries the combined equity of all the subsidiaries; divided by the equity of the holding company. A holding company with a ratio of 100% or less, is not using double leverage. The amount of double leverage a holding company can comfortably carry can depend on various factors; but analysis should center on the amount of earnings or cash flow which the subsidiaries, or the lead bank if the lead bank generates most of the combined company's earnings, can upstream to the parent. Even holding companies with comparatively modest double leverage ratios can negatively affect the bank if the non-bank subsidiaries produce negative cash flow. Other leverage ratios which attempt to isolate or incorporate different segments of the holding company's capital structure (preferred stock or minority interests for example) can be useful for assessing more complex organizations.

Fixed charge coverage is a ratio that measures the ability of the parent company to cover its interest expense. The ratio is computed by determining how many times the parent's total interest expense is "covered" by the net of parent operating income (excluding "equity in undistributed earnings") less parent operating expenses other than interest and taxes. Interest expense is defined to include one- third of parent rental expense (if any), as though premises and equipment had been mortgaged rather than leased. A bank holding company parent's position is generally considered comfortable if it shows a coverage ratio of 2 times or better. A ratio of less than 1 points to a condition of cash flow deficit, without taking debt amortization or shareholder dividends into consideration. This ratio can be misleading if there is an abnormal dividend payout from subsidiaries, the major source of income to a parent. If the payout of all subsidiaries is only 20 percent (but could be 60 percent), the coverage ratio could be very low, perhaps well under 2 times. Conversely, if the payout of earnings is an unsustainable high 90 percent, the coverage ratio could temporarily appear adequate. Therefore, it is essential to be aware of actual dividend payout from subsidiaries to the parent before final interpretation of this ratio.

Cash flow match is a more severe test of parent cash availability to meet not only interest expenses, but also operating expenses, taxes, shareholder dividends, and debt maturities. Cash "sources" are defined as all parent operating income plus tax credit (or minus taxes paid). Cash "uses" are defined as operating expenses (including interest), dividends to shareholders, and debt principal due in one year. A coverage ratio of 1.10 "times" (i.e., cash sources are 110 percent of uses) is generally considered comfortable. Many highly profitable, underleveraged BHCs reflect ratios of 1.20 times or better. Ratios under 1.00 need additional study, as the presumption is that cash flow is insufficient to maintain BHC credit, which bears upon the viability of the institution. Like the fixed-charge coverage test, this ratio also needs adjustment to be interpreted in light of subsidiaries' dividend levels. The amount of debt due in one year usually does not reflect a normalized amortization schedule, since balloon and bullet maturities create a year-to-year instability in the "amount due." If sufficient data were available, it would be more appropriate to arbitrarily introduce a "normalized" amortization schedule based on the average life of parent debt outstanding. Finally, not all parent debt needs to be serviced from parent operating income. Much of this debt is covered or matched by advances to profitable subsidiaries, so that servicing of principal is in essence automatic. Therefore, a true cash flow test would apply only to "uncovered" parent debt and only the amortization of this portion needs to be normalized in the manner described.

These cash flow measures are the best indicators of the financial support a parent company can provide to a subsidiary bank. Asset size, capitalization, revenue or profitability; even relative to the size of the insured institution, are imperfect measures for gauging potential support.

Other ratios that can be used when analyzing holding companies are included on the Relationship with Affiliates and Holding Companies page of the Report of Examination. These ratios are generally available from the Uniform Bank Holding Company Performance Report.

Economies of Scale

The holding company structure can provide significant benefits from economies of scale in areas such as audit, and data processing services, etc. Effective review of the examination report by the holding company and implementation of recommendations contained therein should assist the FDIC in the supervision of subsidiary banks.

Dual Employees

These economies of scale could extend to the employees in the case of “dual employees” or those that perform essentially the same duties for a banking entity and the affiliated organization. The use of dual-employees can be a cost-effective manner for leveraging in-house expertise or for employees that specialize in certain core competencies. Nonetheless, the use of dual-employee arrangements may present increased risk to an insured banking entity if the institution, or its management, fails to adequately monitor the hiring, training, activities, reporting, or expertise of dual-employees.

Any dual officer or employee arrangements should be consistent with sound principles of corporate governance. All bank activities, including those performed by dual employees, should be subject to the authority of an independent board of directors. Bank officers (whether they are dual employees or direct employees) must have sufficient expertise, authority, and information to act in the best interests of the insured institution at all times, under the direction of the board. A comprehensive framework of policies, procedures, legal agreements, controls, and audit must be established to govern the activities of dual officers and employees. A formal written employee sharing agreement should be established to define the employment relationship between the banking entity and affiliate. The following factors should be addressed:

- The agreement needs to be independently reviewed by the bank's board of directors to ensure that it is fair and in the best interest of the insured bank.
- Compensation arrangements need to be clearly delineated to ensure they are equitable for both the bank and affiliated entity.
- The location where the dual employee is to perform duties needs to be established and detailed, along with reporting and authority.
- The agreement should require dual employees to avoid conflicts of interest. Additionally, the agreement should state that dual employees or officers must act in the best interest of the bank while performing any activities on behalf of the bank.
- Sanctions for noncompliance should be contained in the bank's agreement.
- The agreement should provide for a periodic determination concerning the status of a dual-employee and the factors to be considered for terminating the dual-employee relationship in favor of either full-time bank or affiliated entity employment.
- Authority for managing the dual-employee relationships should be clearly assigned.
- Lines of authority for dual employees should be established. While dual employees may have other responsibilities, they must also report through appropriate lines of authority within the banking institution. The dual employee's bank responsibilities and decision-making should take precedence over any affiliate responsibilities. All activities conducted on behalf of the bank must be subject to appropriate review and authorization by bank officers, and ultimately the bank's board of directors.

Affiliate officers and employees who conduct activities on behalf of the bank (even if not formally designated as dual employees) are subject to the same level of legal and corporate duties and liabilities as a direct officer or employee of the bank. Additionally, examiners should have reasonable access to dual employees and any other affiliate employees who perform services on behalf of the bank.

Bank officers must retain control over certain key functions, including general ledger entries, regulatory reporting, cash accounts, lending activities, and investments. While dual officers and employees can provide advice and other supporting services, bank officers must retain final decision making authority. Reasonable systems should be established to ensure that bank officers have sufficient information to oversee the activities of dual officers and employees who provide services to the bank.

The institution needs to be able to devote sufficient resources for monitoring and measuring performance under the terms of the employment sharing agreement.

The extent of the relationships, including the amount of time devoted between the bank and an affiliated entity, need to be periodically reported to the directorate or an appropriate committee.

The insured banking institution utilizing a dual-employee needs to have policies and procedures in place covering account settlement for dual-employees that stipulate the manner and timing for payment in order to ensure an unanticipated affiliated loan does not occur in contravention of Sections 23A & 23B of the FR Act.

Policies and procedures dealing with dual-employee relationships should include a mechanism to ensure compliance with 12 U.S.C 1831g (Adverse Contracts). Under that statute, an institution may not enter into a written or oral contract with any person to provide goods, products, or services to, or for the benefit of, a depository institution if the performance of such contract would adversely affect the safety and soundness of the insured institution.

Examiners should review and evaluate arrangements involving shared employees and/or management for the items discussed above.

Miscellaneous Considerations

The principal benefit of bank holding companies is the tax benefit from issuing debt at the parent company level and concurrently creating equity at the bank level. Most one bank holding companies which engage in minimal other activity aside from holding the stock of the bank, were created for this purpose. The Federal Reserve ruling permitting treatment of Trust Preferred Stock as Tier 1 capital for regulatory purposes, while simultaneously allowing the consolidated holding company to treat it as debt for tax purposes, further added to the attractions of the one bank holding company.

Many of the smaller one-bank holding companies receive infrequent inspection by the Federal Reserve. Ordinarily the holding company financial statements reflect little more than the bank investment and acquisition debt. It is expected that where debt-servicing requirements may impact bank earnings, appropriate comments will be made by the examiner in the examination report. Reference is made to the Earnings section of this Manual as well as the instructions for the preparation of the Relationships with Affiliates and Holding Company report page.

Another major benefit to an individual bank that belongs to a multi-bank holding company is that it can better serve its customers by participating loans exceeding its legal lending limit. A problem could result from this practice if the loan granted exceeds the management expertise of any of the participants.

Examiners should review and evaluate current business plans and any changes thereto since the previous examination. Business plans in most instances should be reduced to written form. It is recognized that the depth and detail of written plans may properly vary, depending on the nature, scope and complexity of their operations. Occasionally, examiners may encounter situations where written plans have not been developed. In these instances, frequent and ongoing communication with management is imperative. The necessity for a written plan may be inferred from the results achieved by management to a considerable degree.

Examiners should assess whether all service relationships provided by affiliates are governed by a written agreement. Refer to Sections 23A and 23B of the FR Act for additional information on affiliate transactions.

Examiners should also determine whether the bank should have a contingency plan for all critical business functions performed by affiliated companies. Refer to outstanding Information Technology (IT) examination guidance for specifics on contingency planning.

The Potential Impact of Holding Companies on Uniform Bank Ratings

The relationship between a bank and its parent holding company and the financial condition of the holding company could affect, to a significant degree, each of the component factors in the CAMELS rating as well as the composite rating.

The financial, technical, and managerial capacity of holding companies, commercial parents, and other affiliates can provide significant and often substantial support to a subsidiary bank. This is particularly true when the bank is a comparatively small component of a much larger corporate organization.

It will not always be necessary for examiners to conduct a detailed assessment of whether a parent company can be considered a source of strength for the subsidiary financial institution. If the subsidiary bank ratings are not dependent on the resources or support of the holding company, it will not normally be necessary to conduct a detailed assessment of the parent company or affiliates. Most bank holding companies have little financial capacity independent of the bank; and are likely to provide little independent support.

In the case where a complex commercial parent company has the potential capacity to support the subsidiary bank but does not clearly dominate the bank by virtue of size, revenues, or earnings, a more detailed examination of the parent may have to be conducted if it should become necessary to show conclusively that the bank ratings should reflect the holding company as a source of strength. However, conduct of a parent company examination should be dependent first on the independent financial condition of the insured institution, the extent of risk exposure resulting from direct transactions between the insured institution and the parent company, and the extent to which the capacity of the parent company supports the Uniform Bank Ratings assigned.

When a holding company or parent is considered a potential source of strength to the insured institution, the weight of this influence on the assigned Uniform Bank Ratings should only incorporate the actual support provided at the current examination. A potential source of strength determination should not be based on projected future resources of the parent, but rather on a current assessment of the parent's actual financial condition. Furthermore, the benefits of parental resources and the influence of these resources on the Uniform Bank Ratings will likely change if the condition of the insured institution deteriorates. In this event, evaluation of potential source of strength should incorporate not just the capacity of the parent to support the bank, but also its present willingness to do so.

Some additional factors that may be considered in assigning a rating to the financial institution subsidiary could include:

- Capital – the ability and commitment of affiliates to contribute additional capital if needed and an assessment of the pressure from the parent organization for dividends.
- Asset Quality – the quality of the assets generated through programs associated with affiliates; ability of affiliates to provide financial guarantees or collateral, purchase low quality assets, or to arrange or develop risk mitigation transactions such as credit default swaps.
- Management – independence of management and the board of directors; ability of the financial institution affiliate to make decisions independent of parent company; adequacy of audit procedures; demonstrated willingness to address examination recommendations and follow safety and soundness principles; documentation and protocols for affiliate relationships.

- Earnings - reasonable fee structure of servicing relationships; suitability of management fees paid to affiliates.
- Liquidity – access to funding sources that would not otherwise be available.
- Sensitivity – funds management strategies that are coordinated with those of affiliates; efficacy of hedging or other market activities employed by affiliates.

TYING ARRANGEMENTS

The Bank Holding Company Act Amendments of 1970 and Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 added the so-called anti-tie-in provisions to the BHC Act. (See "Tying Arrangements" under the Bank Holding Company Act tab in the Prentice-Hall volumes.) Non-bank banks, including ILCs, are subject to the anti-tying provisions of the BHC Act as well.

Essentially, the anti-tying provisions prohibit a bank from conditioning the availability or price of any of its products or services upon the customer obtaining some other product or service from the bank or an affiliate, or upon the customer providing some other product or service to the bank or an affiliate. These provisions also preclude a bank from tying its products or services to a requirement that the customer not obtain some product or service from a competitor of the bank or an affiliate. The purpose of these provisions is to prevent banks from using their ability to offer financial products, credit in particular, in a coercive manner to gain a competitive advantage in markets for nonbanking products and services. For example, a bank may not require as a necessary condition to obtaining a loan or extension of credit that the prospective borrower lease personal property or equipment from the bank's holding company or a subsidiary thereof or that the prospective borrower provide the bank, its holding company or any subsidiary thereof with office supplies or equipment.

However, it is not intended that this provision interfere with the conduct of traditional banking practices. For example, a bank may restrict the availability or vary the price of its credit, property, or services on the condition that the customer also obtains a traditional bank product from the bank or an affiliate. A "traditional bank product" is a loan, discount, deposit, and trust service. For further information regarding other exceptions and safe harbors contact Regional Office staff. For purposes of these provisions, a natural person is treated as a bank holding company if he or she controls a bank or a company that controls a bank.

Violations of these anti-tying provisions may be addressed by the bank's appropriate Federal banking agency through an enforcement action, by United States Attorneys under the direction of the Attorney General through an action for injunctive relief, or by private parties through an action for injunctive relief as well as treble damages when they have sustained damages, or are threatened by loss or damage, by reason of a violation of these provisions.

Prohibition of Preferential Loans

Title VIII essentially prohibits preferential loans to executive officers, directors, and principal shareholders of a bank from its correspondent bank. Therefore, a bank which maintains a correspondent account for another bank is precluded from making an extension of credit on preferential terms to an executive officer, director, or principal shareholder of that bank, and a bank is precluded from opening a correspondent account for another bank if such bank has outstanding an extension of credit to an executive officer, director, or principal shareholder of that bank if it is on preferential terms. Conversely, a bank which maintains a correspondent account at another bank is precluded from making an extension of credit on preferential terms to an executive officer, director, or principal shareholder of that bank, and a bank is precluded from opening a correspondent account at another bank if such bank has outstanding an extension of credit to an executive officer, director, or principal shareholder of that bank on preferential terms. Any bank that violates or any officer, director, employee, agent, or other person participating in the conduct of the affairs of such bank who violates this prohibition shall forfeit and pay a civil penalty.

CHAIN BANKING GROUPS

From a supervisory standpoint, chain-banking groups are very similar in character to multibank holding companies. They have the ability to provide many of the benefits common to multibank holding companies as well as the ability to provide the potential for unsafe and unsound banking practices. The linkage of several banks or holding companies into a chain creates a concentration of banking resources that can be susceptible to common risks. Mutually shared risks that can arise in chain banking relationships include: poor loan participation practices, common deficiencies in lending and/or investment policies, domineering or absentee ownership, insider abuses or other self-serving practices. Unfortunately, detection and correction of these problems are largely dependent on the examination process and are complicated when the chain is composed of institutions subject to different Federal and/or State regulatory agencies.

Unlike multibank holding companies, chain banking organizations do not have to report financial information on a consolidated basis, thereby making offsite monitoring difficult. In addition, they are not subject to the same types of regulations as holding companies.

A chain banking organization is defined as a group (two or more) of banks or savings and loan associations and/or their holding companies which are controlled directly or indirectly by an individual or a company acting alone or through or in concert with any other individual or company. Control is defined as: ownership, control or power to vote 25 percent or more of an organization's voting securities; the power to control in any manner of the election of a majority of the directors of an organization; or the power to exercise a controlling influence over the management or policies of an organization. These criteria are to be interpreted narrowly. For example, institutions should not be deemed to be a chain organization simply because an individual holds a title such as chairman or president unless the individual actually has control.

The control structure of a chain organization is often complex. There may be registered holding companies within the ownership or control structure of a chain organization, but it would not be deemed to be a chain if the top holder of all the insured institutions in the group is a registered holding company. One bank under a bank holding company or several banks owned by a single bank holding company are not considered a chain banking group for purposes of maintaining a list of chain banking groups.

It is the policy of the Division of Supervision and Consumer Protection to monitor and supervise banks that are a part of a chain banking organization in a manner that fully considers the consolidated chain's financial impact on the safety and soundness of the individual institution(s). The supervisory strategy for monitoring chain organizations is included in the Case Manager’s Procedures Manual.

In developing an overall supervisory strategy for chain organizations, the following factors should be considered:

- The relative size and complexity of the chain's organizational structure, including the degree of centralization of operations,
- The degree and nature of control or influence being exerted over individual institutions in the chain and the managerial style and extent of direct control or influence at each institution in the chain,
- The degree of interdependence among institutions in the chain. Particular emphasis should be given to the volume and frequency of inter-institution transactions such as: loan participations or sales; purchases or sales of securities or other assets; bank holding company or bank stock loans; insider loans or transactions; and contractual obligations for services, and
- The overall condition of the institutions in the group and the condition of the chain on a consolidated basis.

AFFILIATES

The relationship of a bank with its affiliated organizations is important to the analysis of the condition of the bank itself. Because of the commonality of ownership or management that exists, transactions with affiliates may not be subject to the same sort of objective analysis that exists in transactions between independent parties. Also, affiliates offer an opportunity to engage in types of business endeavors that are prohibited to the bank itself yet those endeavors may affect the condition of the bank.

In recognition of the importance of relationships with affiliated organizations, the FDIC has been granted authority, under certain conditions, to examine affiliates in connection with its examination of a bank.

There are two primary definitions of "affiliate" which are of importance to examiners. The first is the definition set forth in Section 2(b) of the Banking Act of 1933. The second is the definition set forth in Section 23A of the Federal Reserve Act.

Affiliates as Defined in Section 23A of the Federal Reserve Act

Section 23A of the FR Act (made applicable to insured nonmember banks by Section 18(j) of the FDI Act) contains the restrictive provisions relating to transactions between banks and their affiliates.

Prior to the GLBA amendments to Sections 23A and 23B, non-bank subsidiaries of banks were not covered by the definition of “affiliate.” Those sections now provide that non-bank subsidiaries of state banks are “affiliates” in the event that they qualify as “financial subsidiaries.” The GLBA amendments to Sections 23A and 23B apply solely to covered transactions between a state nonmember bank and its “financial subsidiaries” as covered in Section 46 of the FDI Act.

The principal purpose of Section 23A is to safeguard the resources of banks against misuse for the benefit of organizations under common control with the bank. It was designed to prevent a bank from risking too large an amount in affiliated enterprises and to assure that extensions of credit to affiliates are properly collateralized. Section 23A, therefore, regulates loans or extensions of credit to and investments in affiliates of an insured bank in two ways; first, by restricting the amount of such loans or extensions of credit and investments, and second, by requiring that the loans or extensions of credit meet certain standards as to collateral. Four major types of affiliates are defined in Section 23A and these are discussed in the following paragraphs.

Parent Holding Company and Its Subsidiaries

The first type pertains to a parent holding company and its subsidiaries. Any company that controls the bank (holding company) as well as any other company that is controlled by the company controlling the bank (sister subsidiary) is considered to be an affiliate of the bank under Section 23A. "Control" is defined as owning, controlling, or having the power to vote (directly or indirectly) 25 percent or more of any class of voting securities; or controlling in any manner the election of a majority of the directors or trustees. The term "company" means a corporation, partnership, business trust, association, or similar organization. These definitions are very similar, although not identical, to the definitions of "control" and "company" used in the BHC Act. It is therefore possible to have a holding company-subsidiary relationship under the BHC Act that is not an affiliate relationship for the purposes of Section 23A. Control relationships existing in certain types of trusts are an example.

Section 23A grants an important exemption with respect to domestic banks that are affiliated under this definition. When a bank is 80 percent controlled by a holding company, its transactions with other banks which are also 80 percent controlled by the same holding company are largely unrestricted. The only restrictions which do apply are the general prohibitions against a bank purchasing low-quality assets from its affiliates (refer to "Restrictions on Covered Transactions with Affiliates" below for a definition of "low quality asset"), and a requirement that all transactions be consistent with safe and sound banking practices. All restrictions and limitations set forth in Section 23A are, however, applicable to transactions by a bank with its parent holding company, its non-bank subsidiaries, and its bank subsidiaries that do not meet the 80 percent exemption. They also apply to an affiliated foreign bank even where the 80 percent test is met. The rationale for the 80 percent ownership test is that it is the minimum ownership generally required for the preparation of consolidated Federal income tax returns.

Bank Subsidiaries

The second category consists of bank subsidiaries of a bank. A domestic bank, which is controlled by another bank, is an affiliate of the controlling institution for the purposes of Section 23A. Where such bank is, however, 80 percent controlled, it is granted the same exemption described above relative to sister bank affiliates in a holding company organization. Thus, the treatment of domestic bank affiliates is consistent whether the bank is affiliated through a holding company or by virtue of direct ownership or control.

A different situation exists with respect to non-bank and foreign bank subsidiaries. Directly owned subsidiaries of this type, whether majority or minority owned, are excluded from the definition of an affiliate for the purposes of Section 23A. This is in contrast to the treatment of such firms when they are holding company subsidiaries. As noted above, non-bank and foreign bank subsidiaries of a holding company are affiliates and are subject to the restrictions of Section 23A. The rationale for this contrast in treatment is that non-bank subsidiaries, when majority owned by a bank, are really an integral part of the bank and transactions between the two should not normally be restricted. With respect to minority owned nonbank subsidiaries, it is noted that most banks are restricted in their ability to own stock and several of the more common types of nonbank subsidiaries (such as bank premises and safe deposit companies) are specifically exempted anyway. While this rationale serves to mitigate concern for transactions with non-bank subsidiaries in many instances, situations may arise where a bank can be exposed to undue risk. For instance, in some states banks may be able to conduct types of businesses through a non-bank subsidiary that would be prohibited to the bank itself. While the bank's investment in such a company may be limited, there may be no restriction on the amount of loans that could be made to the affiliate to fund its operations. Where evidence exists that a particular non-bank subsidiary should be brought under the restrictions of Section 23A, this can be accomplished by specific order or regulation. Any such recommendation should be forwarded to the Regional Office accompanied by supporting information.

Interlocking Companies

The third category of affiliates may be referred to as companies interlocked with a banking organization. Any company that is interlocked with a bank or its holding company by virtue of common ownership or common directors is an affiliate of the bank for the purposes of

Section 23A. Such interlocks will arise any time that 25 percent or more of a company is owned, directly or indirectly, by or for the benefit of shareholders who have a direct or indirect ownership of 25 percent or more in either the bank or its parent holding company; or a majority of a company's board of directors also comprise a majority of the board of the bank or its parent holding company. This definition may frequently be applicable to chains of one-bank holding companies that are interlocked by ownership or board membership at the holding company level. Under this definition both the chain of holding companies and their subsidiary banks will be affiliates of a bank under examination if either of the above relevant criteria is met.

Sponsored and Advised Affiliates

The final category is comprised of sponsored and advised affiliates. For the purposes of Section 23A, a company that is sponsored and advised on a contractual basis by a bank, or by any of the bank's subsidiaries or affiliates, is an affiliate of the bank. Real estate investment trusts are an example of this type of affiliation.

Any investment company that a bank or any of its subsidiaries or affiliates serves as an investment advisor is an affiliate of the bank. An investment advisor is basically one who, pursuant to a contract, regularly furnishes advice with respect to the desirability of investing in, purchasing or selling securities, or is empowered to determine what securities shall be purchased or sold by the investment company. The rationale for the inclusion of these two types of affiliations is that banks may, in order to protect their reputation or to forestall lawsuits alleging that bad advice was given, engage in less than arms length transactions. By applying the provisions of Section 23A to such situations, a bank's potential exposure to loss can be controlled.

Additional Considerations

In addition to the four categories of affiliates defined above, Section 23A also gives to the Board of Governors of the Federal Reserve System considerable latitude in defining which companies are or are not affiliated. This can be accomplished in three ways:

1. The Board of Governors may determine that "control" exists in individual situations not coming within the control definition of the FR Act after giving notice of and opportunity for a hearing. For example, the FRB may determine that a company owning less than 25 percent of a bank's stock nonetheless exercises control over the bank and is therefore an affiliate.
2. The Board of Governors may also determine that an affiliate relationship exists in specific instances by order or regulation. For instance, the FRB may determine that the relationship between an exempted subsidiary and its parent bank is such that the potential for abusive transactions exists. The FRB may issue an order or regulation bringing transactions with such company under the provisions of Section 23A.
3. The FRB also has the power to issue an order or regulation exempting specific types of transactions or affiliate relationships from the restrictions of Section 23A, provided that it finds that such exemption is in the public interest and consistent with the purposes of the FR Act.

Two final notes relating to the definition of affiliates under Section 23A concern "control" held in a trust capacity and companies acquired for debts previously contracted.

The FR Act specifies that no company shall be deemed to own or control another company by virtue of its ownership of shares in a fiduciary capacity with two exceptions. The first relates to affiliations arising out of the "Interlocking Companies" definition. Under this definition a company is an affiliate under a trust relationship whereby a trustee controls 25 percent or more of the voting shares of a company for the benefit of shareholders who control 25 percent or more of the voting shares of a bank or its holding company. The other exception provides that ownership or control of one company by another through a business trust creates an affiliate relationship.

With respect to the acquisition of control through debts previously contracted, the FR Act specifies that such companies are not affiliates for whatever period of time applicable State or Federal law or regulation permits the bank to hold such shares. In the absence of any such law the holding period is two years from the date of acquisition upon a showing of good cause. After the expiration of the allowable holding periods, such companies are deemed affiliates.

Restrictions on "Covered Transactions" with Affiliates

Section 23A (a)(1) permits a bank to engage in covered transactions with affiliates so long as the covered transactions do not exceed, in the aggregate; (1) 10 percent of the bank's capital stock and surplus with respect to a single affiliate; (The GLBA exempted transactions between banks and their financial subsidiaries from this requirement) and (2) 20 percent of capital and surplus with respect to all affiliates. (For this maximum percentage, the GLBA provides that a bank’s investment in a financial subsidiary will not include the retained earnings of the subsidiary in the calculation). Both the FRB and the FDIC have previously interpreted capital stock and surplus to include undivided profits, capital reserves, the loan valuation reserves, and valuation reserves for securities. The GLBA added a form of "anti-evasion" protection regarding the aggregate transaction limits and collateral requirements in Section 23A and the transaction restrictions in Section 23B. Any purchase of, or investment in, the securities of a "financial subsidiary" of a bank by an affiliate of the bank will be considered a purchase of or investment in such securities by the bank.

Covered transactions are specifically described in Section 23A (b)(7)(A) through (E) but basically consist of:

- Loans to an affiliate,
- Purchase of securities issued by an affiliate,
- Purchase of nonexempt assets from an affiliate,
- Acceptance of securities issued by an affiliated company as collateral for any loan, and
- Issuance of a guarantee, acceptance, or letter of credit on behalf of (for the account of) an affiliate.

Reference is made to Section 23A (d)(2) through (7) for a listing of several types of transactions that are specifically exempted from the provisions of Section 23A. These transactions basically consist of deposit balances in bank affiliates, loans secured by U.S. or agency securities or deposit balances in the bank, readily marketable assets purchased at quoted market prices, loans purchased on a nonrecourse basis from affiliated banks, and the repurchase of loans previously sold to an affiliate with recourse.

The FR Act also contains two other important general provisions that relate to covered and exempted transactions. A bank may not purchase any "low quality asset" from an affiliate in any amount unless, pursuant to an independent credit evaluation, the bank had committed itself to purchase such asset prior to the time such asset was acquired by the affiliate. A "low quality asset" is defined as:

- An asset which was classified as "substandard," "doubtful," or "loss" or treated as "other loans especially mentioned" in the most recent report of examination or inspection of an affiliate prepared by either a State or Federal supervisory agency,
- An asset in a nonaccrual status because of deteriorating credit quality and/or past due status,
- An asset on which principal or interest payments are more than 30 days past due, or
- An asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.

This prohibition on the purchase of low quality assets also extends to bank subsidiaries. In other words, neither a bank nor any of its subsidiaries may purchase low quality assets from an affiliate. The other provision is more general but has a similar intent. This provision requires that any covered transaction between a bank and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices.

For purposes of illustration, the following loan purchase transactions provide examples of the application of Section 23A which examiners may find useful.

1. Loans Purchased from Non-Bank Subsidiaries - A bank may purchase any loan, including a classified loan, from its own non-bank subsidiaries since such companies are not considered affiliates under Section 23A. It does not matter whether the subsidiary is minority or majority owned. The only way to control such possibly objectionable activity, other than through use of Section 8 powers, would be to have the nonbank subsidiary brought under the restrictions of 23A by order or regulation.
2. Loans Purchased from Domestic Banks which are 80 Percent Owned by Either the Bank or its Parent Holding Company - A bank may purchase loans in any amount from these affiliates provided they are not "low quality" or constitute "unsound" transactions under the provisions of Section 23A. The loans may be either subject to repurchase by the affiliate or not subject to repurchase.
3. Loans Purchased from Parent Holding Company, Sister Non-Bank Affiliates, Interlocking Non-Bank Affiliates, Sponsored Affiliates and Foreign Bank Affiliates - A bank may purchase good quality loans from these affiliates subject to the 10-20 percent capital stock and surplus limitations. Other covered transactions are aggregated for purposes of applying the amount limitations. Low quality loans or loans whose terms and conditions are unsound may not be purchased in any amount. Loans secured by U.S. securities or repurchased loans which had been sold earlier by the bank to the affiliate on a with-recourse basis are exempted, however, and would be excluded in applying the amount limitations.
4. Loans Purchased from Other Domestic Bank Affiliates - These affiliates are domestic banks controlled by either the bank or its parent holding company but which are less than 80 percent owned. This also includes banks controlled by interlocking affiliates (one-bank holding company chains, for example)

whether more than or less than 80 percent owned. Loan purchase transactions with these affiliates are treated the same as loan transactions with the parent holding company, etc. (#3 above) with one exception; good quality loans may be purchased in any amount provided they are sold by the affiliated bank on a non-recourse basis.

Collateral Requirements

Loans may not be extended directly to an affiliate nor may a bank issue guarantees, acceptances, or letters of credit for the account of an affiliate unless certain collateral and margin requirements are met. Eligible collateral and margins are as follows:

- 100 percent collateral margin if the collateral consists of U.S. Government and agency securities, deposits held in the bank which are specifically segregated and earmarked, or obligations (such as notes, drafts, or acceptances) which are eligible for rediscount or purchase by a Federal Reserve Bank,
- A 110 percent margin is required if the collateral is composed of obligations of a state or political subdivision of a state,
- A 120 percent margin is required if the collateral consists of other types of debt instruments, including receivables, and
- A 130 percent margin is required if the collateral is composed of stocks, leases, or other real or personal property.

It is important to note that market value at the time of the transaction is the appropriate basis for meeting margin requirements in all instances. When any collateral is subsequently retired or amortized and the amount of the remaining collateral does not provide a sufficient margin, additional eligible collateral must be supplied in an amount sufficient to meet the collateral margin required at the inception of the transaction. Where no collateral substitutions or amortizations are involved, a shrinkage in collateral value does not create a violation so long as the margin requirement was met at the inception of the transaction.

As noted above almost any type security is acceptable (provided margin requirements are met) subject to two important limitations. First, low quality assets; as that term is defined, may not be used to meet collateral requirements and, secondly, securities issued by an affiliate of a bank may not be used to secure the obligations of that affiliate or any other affiliate of the bank.

Section 23B of the Federal Reserve Act

Section 23B of the FR Act applies to insured nonmember banks through Section 18(j) of the FDI Act. Violations of Section 23B by nonmember banks are subject to the civil money penalties of subsection (3)(A) of Section 18(j). Section 23B essentially imposes the following four restrictions:

1. A requirement that the terms of affiliate transactions be comparable to terms of similar non-affiliate transactions;
2. A restriction on the extent that a bank may, as a fiduciary, purchase securities and other assets from an affiliate;
3. A restriction on the purchase of securities where an affiliate is the principal underwriter; and
4. A prohibition on agreements and advertising providing or suggesting that a bank is responsible for the obligations of its affiliates.

Section 23B generally incorporates the definitions used in Section 23A; however, banks are not "affiliates" for purposes of Section 23B.

SUBSIDIARIES

A bank subsidiary, as defined by Section 23A of the FR Act, is any company of which 25 percent or more of any class of its voting stock is owned, controlled, or may be voted by the bank; or any company with respect to which the bank controls, in any manner, the election of a majority of its directors or trustees. While several types of subsidiaries (such as bank premises companies or safe deposit companies) have long been excluded from the provisions of Section 23A, post-GLBA, the amendments to 23A and 23B provide that non-bank subsidiaries of state banks are “affiliates” in the event that they qualify as “financial subsidiaries” under new Section 46 of the FDI Act.

The overall condition of a subsidiary can substantially affect the affairs and soundness of a bank. For example, a subsidiary in severe financial distress could precipitate a drain on the management and financial resources of the bank. To determine the overall risk that the functionally regulated entity presents to the insured depository institution as a whole, it is necessary to determine which subsidiaries are functionally regulated within the functional regulation confines (refer to applicable subsection of this chapter).

Requirements for consolidation of subsidiaries are contained in the Call Reports Instructions for essentially all majority-owned bank premises subsidiaries and other majority-owned subsidiaries, which are considered significant according to certain tests, are consolidated. Some major types of subsidiaries are addressed below:

Bank Service Corporation

A bank service corporation is defined in the Bank Service Corporation Act (BSC Act) as a corporation, whose capital stock is all owned by one or more insured banks, organized to perform "authorized services." The BSC Act limits the investment of a bank in a bank service corporation and specifies prior regulatory approval requirements. Authorized services are defined to include services such as: check and deposit sorting and posting, computation and posting of interest and other credits and charges, preparation and mailing of checks, statements, notices, and similar items, or any other clerical, bookkeeping, accounting, statistical, or similar function performed for a bank. In addition, a bank service corporation may perform any services permitted by FR regulation for a bank holding company under Section 4(c) (8) of the BHC Act.

Due to the nature of services performed by these corporations, the importance of analyzing their financial condition is obvious. In addition to authority to examine affiliates the BSC Act provides that for any bank regularly examined by a Federal supervisory agency or any subsidiary or affiliate of such bank subject to examination by that agency, which causes to be performed by contract or otherwise, any bank services for itself, whether on or off premises, such performance shall be subject to regulation and examination by such agency to the same extent as if the services were being performed by the bank itself on its own premises. The bank is also required to notify the appropriate agency of the existence of such a service relationship within 30 days after the making of the service contract or the performance of the service, whichever comes first.

Safe Deposit Corporation

A safe deposit corporation primarily performs the same functions as a safe deposit department of a bank. A primary purpose for establishing such a subsidiary is to limit the bank's liability. These corporations generally are established under applicable State statutes that may contain limits on liability of the corporation for loss to a customer in any box or compartment. The safe deposit corporation should be operated under the same set of internal procedures as a normal bank safe deposit department. Additionally, the subsidiary should be protected by a combination safe depository insurance policy to the extent State law liability limitations do not provide adequate protection.

Corporation Holding Title to Bank Premises

As the name suggests, a bank premises subsidiary holds title to the bank premises and, in most cases leases them back to the bank. Oftentimes construction/acquisition of the bank premises is financed with borrowed money and lease terms are designed to service principal and interest payments of the mortgage. State law for nonmember banks generally limits the maximum investment in a bank premises subsidiary. The amount of investment, direct or indirect, by a bank in bank premises can have a significant effect on overall net earnings. Therefore, it is essential when evaluating a bank's condition and earnings, that majority-owned bank premises subsidiaries be fully consolidated.

Securities Firm

A securities firm subsidiary is a subsidiary that:

- Engages in the sale, distribution or underwriting of stocks, bonds, debentures, notes, or other securities,
- Acts as an investment adviser to any investment company,
- Conducts any activity for which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer, or
- Engages in any other securities activity.

Small Business Investment Companies (SBIC)

A SBIC is a company, organized under the Small Business Investment Act of 1958, which provides long-term credit and equity financing for small business concerns. Section 302(b) of that Act authorizes National banks, other member banks, and nonmember insured banks (to the extent permitted by applicable State law), to invest in stock of SBICs not exceeding (in total) 5 percent of the capital and surplus of such banks. In no event may a bank acquire 50 percent or more of the shares of any class of equity securities issued by an SBIC having actual or potential voting rights.

Agricultural Credit Corporation (ACC)

These subsidiaries, established under State law, are generally a means by which a bank can obtain funding to be able to continue to service the borrowing needs of its agricultural customers. The ACC establishes a financing relationship with the Federal Intermediate Credit Bank (FICB) by buying a participation certificate in the FICB. It is then able to borrow a certain percentage of the face value of loans by discounting those loans at the FICB on a full recourse basis. The ACC is examined and regulated by the FICB and any loans classified Doubtful or Loss at the parent bank, which are discounted at the FICB, must be replaced.

Inasmuch as lending limits to ACC's may be separate from and in addition to the bank's limit; care should be taken to avoid a concentration of credit to any individual borrower. Wholly owned ACCs should be examined by the FDIC with classifications reflected in a consolidated balance sheet and analysis of capital.

Special Purpose Finance Subsidiaries

A finance subsidiary is used as a mechanism for raising funds from outside investors through the issuance of collateralized debt or preferred stock. The parent bank places certain assets in the subsidiary to collateralize or otherwise support the securities issued by the subsidiary. Properly used, a finance subsidiary may enhance a bank's efforts to restructure its assets, obtain cheaper and more widely available funding sources, and improve overall profit performance.

Finance subsidiaries can also be used solely for the purpose of generating arbitrage profits rather than for the purpose of obtaining an additional source of funds. For example, a subsidiary might issue collateralized mortgage obligations and use the proceeds to simultaneously buy the mortgage-related collateral that will secure the collateralized mortgage obligation. Thus, the parent bank would receive no additional funds since the proceeds of the securities issuance are used to purchase the underlying collateral.

Bank management has the responsibility to carefully consider the impact of finance subsidiary transactions on the bank's overall financial position. Areas requiring attention include the following:

- Consolidation Requirements. For Reports of Income and Condition filed with the FDIC, subsidiaries that meet any one of the "significance" tests set forth in the Call Report instructions must be consolidated. Thus, securities issued to outside parties by a finance subsidiary that is wholly owned by the parent bank generally would be reported as a liability on the bank's consolidated financial statements.

- Capital Adequacy Considerations. If required to be consolidated with the parent bank for Call Report purposes, these subsidiaries must also be consolidated for purposes of evaluating capital adequacy under the FDIC's Part 324 capital regulation. As a result, finance subsidiary transactions are normally reflected as additional assets and liabilities on the bank's consolidated Report of Condition balance sheet. Because the transactions generally result in an increase in total assets with no increase in capital, the potential negative impact on the capital to asset ratio effectively limits the total dollar volume of such transactions.

- In addition, banks should carefully evaluate their overall asset/liability management, funding, and liquidity management strategies prior to entering into any proposed finance subsidiary transaction. In situations where finance subsidiary transactions are concluded in an unsafe or unsound manner, examiners should seek appropriate supervisory remedies.

Corporations Engaged in International Banking Activities

Edge Act Corporation - A Federally chartered corporation organized under Section 25(a) of the FR Act and subject to Federal Reserve Regulation K. Edge Act Corporations are allowed to engage only in international banking or other financial transactions related to international business. They are chartered and regulated by the Federal Reserve System and must have a minimum capital of $2,000,000 and a minimum life of 20 years. Their purpose is to aid in financing and stimulating foreign trade. An Edge Act subsidiary is a bank's majority-owned Edge Act Corporation and is treated for purposes of Reports of Income and Condition as a "foreign office."

Agreement Corporation

A State-chartered corporation that has agreed to operate as if it were organized under Section 25 of the FR Act and has agreed to be subject to FR Regulation K (refer to the FDIC Rules and Regulations). Banks must apply to the FR for permission to acquire stock in an Agreement Corporation, which is restricted principally to international banking operations.

Foreign Bank Subsidiary of a Limited Purpose Credit Card Bank

The GLBA adds a new provision to the BHC Act, which permits a credit card bank which is not a bank under the BHC Act to control a foreign bank if the investment in the foreign bank meets the requirements of Section 25 or 25A of the FR Act and the foreign bank qualifies under such sections; the activities of the foreign bank are permissible under otherwise applicable law; and the foreign bank does not offer any products or services in the United States.

Mortgage Banking Subsidiaries

Mortgage banking subsidiaries engage in the origination and/or purchase of mortgages for sale in the secondary market and the servicing of mortgages. The major functions of a mortgage banking subsidiary are:

- Origination, which includes application processing, underwriting, and closing,
- Secondary marketing, which includes purchases and sales, warehousing, packaging and shipping, investor relationships, and risk management, and
- Servicing, which includes mortgage accounting administration, collections, customer service, and investor reporting.

Insurance Subsidiaries

There is considerable variety in the laws and regulations of the states. Some allow bank subsidiaries to engage in insurance agency or brokerage operations, while others do not. Some limit the products that may be offered. Types of insurance products include credit liability, casualty, automobile, life, health, accident, title insurance, and private mortgage insurance. The insurance departments of the various states generally regulate insurance activities.

Real Estate Subsidiaries

State laws vary with respect to permissible real estate activities that may be conducted through bank subsidiaries. A number of states permit real estate brokerage activities. Others permit equity participations, which involve passive investment roles, and some states permit bank subsidiaries to engage in real estate development and ownership in an active role. In many cases investments are limited in terms of percentages of an institution's total assets or capital.

Real estate brokerage, management, development and investment are not permitted for national banks or their subsidiaries. For state non-member banks to invest or develop real estate, this activity must be authorized under State law and approved by the FDIC under Section 24 of the FDI Act. Real estate brokerage is considered to be an agency activity, so no FDIC approval is necessary.

EXAMINATION OF SUBSIDIARIES

Unlike affiliates, whose activities may be shielded from the insured institution through the holding company structure and the provisions of Sections 23A and 23B of the FR Act, the liabilities of a subsidiary may flow directly to the insured institution if appropriate barriers between the insured institution and its subsidiaries are not in place. Even with barriers, the legal precedents are such that there is no guaranty that the liabilities of a subsidiary may not adversely impact the parent. Thus, in order to determine the true condition of the parent organization, the risk presented by the subsidiary to the parent institution needs to be evaluated.

If the subsidiary is functionally regulated, the GLBA requires the FDIC to rely to "the fullest extent possible" on the functional regulator. Therefore, examinations conducted by the appropriate Federal and State regulators of functionally regulated entities should be used, if possible, rather than a direct examination of those entities. Examinations of functionally regulated subsidiaries are generally permissible only if:

- There is a reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to the depository institution,
- That an examination is necessary to assess risk management systems, or
- The subsidiary is not in compliance with a law that the agency has specific jurisdiction to enforce against the subsidiary.

If a high-risk profile is evident, more extensive examination procedures may be required. For a functionally regulated subsidiary, the examiner should contact the Regional Office before proceeding with any direct examination of the subsidiary's records. Any records that the bank maintains, including any written policies and procedures concerning the bank's oversight of the subsidiary, should be reviewed and assessed for adequacy. The objective is for examiners to reach a level of comfort sufficient to assess the overall condition of the subsidiary and its impact on the parent.

The Examination (ED) Modules contain examination procedures for examining subsidiaries. Refer to the Related Organizations section for additional guidance in this area.

Depending on the type of subsidiary, a more in-depth evaluation will generally involve assessment of the following areas:

Asset Quality

The examiner should attempt to ascertain the quality of assets, review delinquency reports where appropriate, and evaluate bank management oversight with respect to the subsidiary and any policies in place to determine the extent of any loss.

Funding and Liquidity

A determination should be made of the types of funding necessary for the subsidiary's activities, the reliability of present funding, and the extent to which the subsidiary's activities are being funded by the bank. An excessive reliance on any one source of funding may indicate future liquidity problems or undue reliance on the parent to provide funding.

Adequacy of Capital

To the extent possible, a determination of the adequacy of the subsidiary's capital should be made after reviewing asset quality, sources of funding, earnings, and management. Capital levels should be compared to regulatory requirements or other standards considered appropriate for the type of business the subsidiary is engaged in. This capital cushion is an important insulation to protect the bank from liabilities of the subsidiary.

In reviewing the parent bank's capital adequacy, the bank's investment in its subsidiary should be deducted from both assets and capital. This analysis will indicate the effect on the parent should the subsidiary become insolvent.

Earnings

The earnings stream of the subsidiary should be reviewed to determine if there is reliance on one time gains or if there is a failure to recognize losses on a timely basis. Fees received from the bank, salary structure and overhead expenses should be reviewed to ensure that charges are in line with those that would be made to third parties.

Management

Daily management of the subsidiary should be structured so as not to create the presumption that the activities of the subsidiaries are in any way conducted by the bank. Advertising and any required disclosures should be reviewed to ensure that the public is not given the perception that subsidiary activities are guaranteed by the bank or insured by the FDIC.

Another important management consideration is “firewalls.” The term "firewalls" is used to describe a concept of separation of responsibility for entities providing different services but which are commonly owned. Firewalls generally include separate corporate formalities, management, employees, accounting, and policies. Also, the operations of the subsidiary should be physically distinct from the operations of the insured institution. Section 362.4(c)(2) of the FDIC Rules and Regulations is an example of a firewall construction designed to insulate the bank from liability of the subsidiary; compliance with Section 362.4(c)(2) should be reviewed where applicable.

EXAMINATION AND INVESTIGATION OF UNAFFILIATED THIRD PARTY SERVICERS

Situations occasionally arise where the safety and soundness of an insured depository institution is materially affected by transactions, contracts or business arrangements with parties that are not affiliated with the institution. When such situations arise, it is necessary for the FDIC to examine the other side of the transaction. The potential impact of these business relationships on the insured depository institution necessitates a complete understanding of the nature of the transaction and relationship and its effect on the insured institution.

By statute, the FDIC has authority to obtain records of unaffiliated service providers and other counterparties relating to an insured financial institution. Such authority is not unqualified but depends on particular facts and circumstances giving rise to inquiries by the FDIC. Several statutory provisions support this conclusion: Sections 10(b) and 10(c) of the FDI Act; Section 7(c) of the BSC Act; and Sections 3(w)(5) and (6) of the FDI Act. The information that the FDIC can obtain from an unaffiliated service provider or other counterparty is not limited to specific transactions with or relating to the insured depository institution but can extend to the financial books and records of the servicer or entity so long as such documents are needed in furtherance of an examination that relates to the affairs of an insured bank.

It is important that examiners are aware of material transactions, service contracts, or other business arrangements that could have a material affect on an insured bank. If it is concluded that information is needed from an unaffiliated service provider or other counterparty to the bank, then the examiner should consult with the Regional Office. The Regional Office will assist the examiner in determining whether information is needed from an unaffiliated service provider, and if so, in obtaining the appropriate information.

Examination authority covering bank service corporations is set out in Section 7 of the BSC Act.

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[1] Qualified Thrift Lender test requires that at least 65% of the institution's assets be qualified thrift investments, primarily residential mortgages and related investments.

[2] Generally, an ILC is excepted from the BHC Act if (A) it was chartered under a State law that on March 5, 1987 required the ILC to have Federal deposit insurance, and (B) it meets at least one of the following conditions: (1) the institution does not accept demand deposits, (2) the institution's total assets are less than $100,000,000, or (3) control of the institution has not been acquired after August 10, 1987.