3. How Great the Cost of “Specialness”? 

Banks are special. They have cheap deposit funding. Time has taught us that this “specialness” must be protected: from deposit runs, from risky activities and investments, from bad decisions, from insider and affiliate abuse. Thus, we have, for example, deposit insurance and access to the Federal Reserve’s discount window as subsidies of enormous consequence. Many argue that their very existence validates supervision, regulation, and enforcement on the scale described in this book.

This chapter discusses three regulatory policies applicable to all depository institutions that are intended to protect them from abuse. We tend to think of these as the foundation of “prudential regulation” because they require banks to exercise “prudence.” Chapter 8 then presents another aspect of protectionism in terms of the restrictions on bank expansion into new and/or riskier activities. These chapters encompass the heart and soul of what a bank regulatory lawyer deals with on an everyday basis as we give advice on whether and how our clients may conduct business.

The policies discussed below apply to all banks and savings associations and frame the fundamentals of “prudential” regulation. Three impose significant restrictions on banks and one is expressed as a commandment instead of a negative and remains the backstop of it all. In a nutshell, all insured depository institutions SHALL:

- Limit transactions with affiliates;

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1. The federal subsidies and the “safety net” are the subject of Chapter 5, supra.
Limit insider loans;
Limit loans to one borrower; and
Not engage in unsafe and unsound banking practices.

The last commandment has become so great in import that it now commands Chapter 7 on its own.

Transactions with Affiliates

Sections 23A and 23B of the Federal Reserve Act (collectively, “Sections 23A and B”)
 impose quantitative and qualitative restrictions on transactions between banks and their affiliates. The Federal Reserve Board (“Board” or “Federal Reserve”) has described these sections as follows:

Sections 23A and 23B of the Federal Reserve Act are important statutory provisions designed to protect against a depository institution suffering losses in transactions with affiliates. They also limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution’s access to the Federal safety net.

Section 23A, which was enacted in 1933, originally applied to banks that were members of the Federal Reserve System (member banks). In fact, the statute still refers solely to “member banks,” causing no end of confusion for young lawyers who may still decide they do not have to read it if the client is a nonmember bank or savings association. Notwithstanding the express words of the statute, it now applies, along with Section 23B, which was enacted in 1987, to federally insured nonmember banks and to all savings associations (referred to collectively with member banks as “banks” in this discussion).

The Board has rulemaking authority under Sections 23A and B but declined to exercise it for decades, relying instead on staff interpretations and informal guidance, much of which was unofficial and some of which stretched beyond the statutory construction. These sections then assumed increasing importance with the enactment of the Gramm-Leach-Bliley Act of 1999 (“Gramm-Leach-Bliley” or “GLBA”). GLBA not only expanded the scope of

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2. Codified at 12 U.S.C. §§ 371c and 371c-1, respectively.
4. Section 8(j) of the Federal Deposit Insurance Act (codified in 12 U.S.C. § 1828(j)).
5. Section 11(a) of the Home Owners’ Loan Act (codified in 12 U.S.C. § 1468(a)). The former regulation at 12 C.F.R. § 163.41 now merely has a direction to Regulation W.
activities in which banks and their subsidiaries could engage with affiliates, but also required the Board to adopt regulations under Section 23A relating to derivative transactions and intraday credit extensions. In response to these developments, the Board adopted final rules implementing these sections, captioned as Regulation W (conveniently the 23rd letter of the alphabet so it is codified at 12 C.F.R. Part 223) (“Regulation W”), and final rules repealing its interpretive rulings, most of which found a home in Regulation W, along with a slew of others.

The principal restrictions under Sections 23A and B may be summarized as follows:

1. Extensions of credit to, asset purchases from, and certain other “covered transactions” by a bank with an affiliate are subject to the following quantitative limits (§§ 223.11–12):
   - 10% of the bank’s capital and surplus to any single affiliate; and
   - 20% of the bank’s capital and surplus to all affiliates;
2. Extensions of credit to and guarantees on behalf of an affiliate must be collateralized (§ 223.14);
3. A bank may not purchase low-quality assets from an affiliate (§ 223.15);
4. All covered transactions by a bank with affiliates must be consistent with safe and sound banking practices (§ 223.13);
5. Section 23B: all transactions by a bank with affiliates must be on market terms (§§ 223.51–52);
6. Attribution rule: transactions by a bank with a third party, the proceeds of which are transferred to an affiliate or that benefit an affiliate, are considered made to the affiliate (§ 223.16).

If a bank has one or more affiliates and contemplates any intra-family transactions, it is incumbent upon the board of directors to adopt a policy statement with respect to its expectations in this area, including naming the responsible parties for approvals and compliance. The policy statement, and any procedures promulgated thereunder, should not merely recite the law. They should provide direction.

**Section 23A**

It is important to note in this regard that Section 23A is all about protecting the bank. For this reason, traditional operating subsidiaries (those that can only engage in the activities of the parent bank and a few others

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7. The formal interpretations of Sections 23A and B were published in 12 C.F.R. Part 225. They were rescinded in 67 Fed. Reg. 76,620 (Dec. 12, 2002).

Described below are treated as part of the protected bank—as if they were an incorporated division. It is useful to imagine a net around the bank and the protected subsidiaries keeping the money from flowing out to affiliates without an express exit permitted under the rules.

**Definitional Challenges**

Section 23A is a very short statute. In its brevity, it depends on numerous definitions. As a consequence, it can only be approached by drilling down into the definitions (some of which are italicized in the following sentence). It limits the amount of a member bank and its operating subsidiary’s covered transactions with a single affiliate to 10% of the bank’s capital stock and surplus, and limits such transactions with all affiliates to 20% of this amount.

**What is a Member Bank?**

As indicated above, “member bank” when used in the statute means any bank or savings association that has Federal Deposit Insurance Corporation (“FDIC”) insurance, or is an “insured depository institution.” For example, any trust company that has FDIC insurance is a bank, but those that do not have insurance, are not.

**What is an Operating Subsidiary?**

A company that is a subsidiary of a bank is generally considered a part of the bank within the protection of Section 23A. A subsidiary is not an “affiliate” unless it is:

- a depository institution;
- directly controlled by one or more affiliates of the bank (other than a depository institution affiliate) or by a shareholder or group of shareholders that control the member bank;
- an employee stock option plan organized for the benefit of employees, shareholders, and others related to the bank; or
- a financial subsidiary, other than one operating solely as an insurance agency.

Treating subsidiaries as part of the bank for the purposes of the transactions with affiliates restrictions makes subsidiaries an ideal structure choice for a number of activities in which the existence of the corporate veil for liability containment purposes may be appropriate.

8. 12 C.F.R. § 223.
10. These subsidiaries are introduced in Chapter 2, supra, and discussed in Chapter 3, supra.
11. See, 12 C.F.R. § 223.3(p)(2)(i). This was a refinement added in Regulation W in deference to the fact that insurance activities did not represent principal risk as would other activities of financial subsidiaries.
**What is an Affiliate?** Affiliates are the entities that the bank is protected from—they are outside the “net.” They are not individuals, although individuals may control the bank and also control another entity that is an affiliate because of the common control. Section 23A defines “affiliates” of banks to include the following:

- a company that controls the bank (bank holding company or savings and loan holding company);
- companies that are under common control by the bank’s parent company or certain other entities, including the common control of the same individual;
- a company a majority of whose directors or general partners comprise a majority of the persons holding similar positions at the bank or the bank’s parent company;
- any investment fund advised by the bank or an affiliate of the bank;
- a company in which the bank and its affiliates control more than 5% of the voting securities or equity capital of the fund;
- a depository institution that is a subsidiary of the bank;
- a partnership or LLC in which the bank or affiliate, or any officer, director, or employee thereof, serves as a general partner or managing member, respectively;
- any subsidiary of the companies described above; and
- any company including a subsidiary of a bank that the Federal Reserve or the primary federal regulator determines to be an affiliate by regulation or order.

Entities excluded from the definition of “affiliate” include certain companies acquired from the exercise of rights arising out of a bona fide debt previously contracted (so-called “DPC” property) and companies engaged solely in: holding the premises of the member bank; a safe deposit box business; and holding U.S. and certain U.S.-guaranteed securities.

**What is Control?** The concept of control is a significant feature of Section 23A in order to determine which entities constitute affiliates. If an entity is not under common control or controlled by the bank, it is not an affiliate. A company or shareholder controls another company if that company or shareholder, directly or indirectly, or acting through one or more other persons:

- owns, controls, or has power to vote 25% or more of any class of voting securities of the other company (including shares held by a subsidiary);

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12. 12 C.F.R. § 223.2.
13. 12 C.F.R. § 223.3(g).
controls in any manner the election of a majority of the directors of the other company; or

is found by the Federal Reserve, after notice and opportunity for hearing, to exercise a controlling influence over the management or policies of the other company.

What is a Covered Transaction? Section 23A only applies to “covered transactions” between a bank and its operating subsidiary and an affiliate. These mostly involve funds leaving the bank. Transactions subject to the 10% and 20% quantitative limits under Section 23A include:

- extensions of credit to, or purchases of assets from, an affiliate, including loans to a third party that benefit an affiliate (see discussion of attribution rules below) and including:
  - any transaction that creates a repayment obligation, including accidental actions that result in accounts payable to an affiliate, including paying the taxes of an affiliate or paying for services rendered on behalf of the affiliate;
  - purchase of a note or obligation of an affiliate;
  - intra-day credit (broadly defined);
  - a purchase of assets subject to a repurchase agreement;
- purchase of, or investment in, a security of an affiliate;
- the acceptance of a security issued by an affiliate as collateral for an extension of credit to any person or company, and the acceptance of other debt obligations of an affiliate as collateral;
- the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate, and the confirmation of a letter of credit issued by the affiliate; and
- cross-affiliate netting arrangements.

Section 608 of Dodd-Frank also adds, as of July 21, 2012:

- a transaction with an affiliate involving the borrowing or lending of securities to the extent the transaction causes the bank to have a credit exposure to the affiliate; and
- a derivative transaction with an affiliate to the extent that it causes the bank to have a credit exposure to the affiliate. (There is no definition yet of the term “credit exposure.”)

14. 12 C.F.R. § 223.3(h).
15. A cross-affiliate netting arrangement is an arrangement between a member bank, one or more affiliates, and one or more nonaffiliates of the bank, in which a nonaffiliate can deduct any obligation of the affiliate to the bank when settling the nonaffiliate’s own obligation to the bank, and when a bank is permitted or required to add any amount owed by the affiliate to the nonaffiliate when settling the bank’s obligations to the nonaffiliate.
In addition, internal reorganizations and other transactions that are not specifically listed above typically involve covered transactions and, therefore, must be carefully scrutinized under the rules. For instance, the donation of a subsidiary by a parent company to a bank involves a covered transaction because the bank is deemed to have purchased the assets with an assumption of liabilities as the purchase price.\textsuperscript{16}

\textbf{Restrictions on Covered Transactions}

When a bank seeks to engage in covered transactions with one or more affiliates, it must comply with all the rules discussed below and, as part of its policies and procedures to assure compliance with the law and Regulation W, it must establish internal controls to carefully monitor lines of credit to keep them under the quantitative limitations and must monitor collateral positions to assure they remain at the required levels.

\textbf{Quantitative Limits.}\textsuperscript{17} Section 23A prohibits a bank or subsidiary from entering into a new covered transaction that would exceed for that affiliate 10\% of the bank’s capital stock and surplus, and for all affiliates 20\% of this amount. The banking agencies have promulgated identical regulations as to how capital is calculated for the purpose of prudential regulations: it is a bank’s Tier 1 and Tier 2 regulatory capital plus the allowance for loan and lease losses (ALLL) not used in the bank’s Tier 2 capital as of the prior CALL report.\textsuperscript{18}

\textbf{Asset Quality.}\textsuperscript{19} A bank may not purchase a “low quality asset” from an affiliate unless, pursuant to an independent credit evaluation, the bank contracted to buy the asset before it was acquired by the affiliate. Low-quality assets include those that have been classified as “sub-standard” or lower in the affiliate’s most recent examination or the bank’s own internal loan rating system, assets on which principal and interest payments are more than 30 days past due, those that are on a nonaccrual basis, and those that have been renegotiated or compromised.

\textbf{Collateral Requirements.}\textsuperscript{20} A bank’s extension of credit to, or guarantees issued on behalf of, an affiliate must be secured by a statutorily mandated amount of collateral. Collateral requirements range from 100\% of the loan if the collateral consists of U.S. government obligations or securities of equivalent safety to 130\% of the loan if the collateral is stock, leases, or other real or personal property. Debt obligations of an affiliate (as well as securities issued by an affiliate) are not permitted to be used as collateral.

\textsuperscript{16} 12 C.F.R. § 223.31.
\textsuperscript{17} 12 C.F.R. §§ 223.11-12.
\textsuperscript{18} See, e.g., 12 C.F.R. § 1.2(a). Capital is discussed in Chapter 4, \textit{supra}.
\textsuperscript{19} 12 C.F.R. § 223.3(v).
\textsuperscript{20} 12 C.F.R. § 223.14.
for an extension of credit to, guarantee on behalf of, or credit exposure on a derivative or securities lending or borrowing transaction with an affiliate. Under Section 608 of Dodd-Frank, beginning on July 21, 2012, a credit extension or guarantee is required to remain secured in accordance with the collateral requirements of Section 23A so long as it is outstanding. Under prior law, the collateral only needed to meet the requirements when the covered transaction was funded. In addition, the collateral requirements of Section 23A apply to the bank’s credit exposure on derivative transactions with an affiliate and with respect to the credit exposure on borrowing or lending transactions with an affiliate.

**Safety and Soundness.** The bank must conduct all covered transactions, including transactions that are exempt from other requirements of Section 23A, on a safe and sound basis.

**Attribution Rule.** Under Section 23A, a loan made to a third party for the benefit of an affiliate is regarded as a loan to the affiliate for purposes of the restrictions. A loan by the bank to a third party used to purchase an item from an affiliate of the bank, or from a company, such as an automobile dealership, that is controlled by persons who also control the bank is deemed to be a loan to the affiliate. There are several notable exceptions to the attribution rule, including a provision that general purpose credit cards, such as Visa and MasterCard, issued by a member bank will be exempt from these attribution rules if less than 25% of the purchases with the card are from an affiliate of the bank. The preamble to the final rules points out that most banks issuing special purpose cards comply with Section 23A by selling receivables to an affiliate at the end of each day.

**Exemptions from the Provisions of Section 23A**

The first list of exemptions and the lists following it closely track statutory exemptions in Section 23A(d)(6) from the quantitative limits and certain other restrictions of Section 23A. All of the transactions listed, however, are subject to the requirements that any transactions with affiliates be conducted on a safe and sound basis. The transactions listed first below are also subject to the prohibition on transactions involving low-quality assets, discussed above. These exempt transactions are:

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22. 12 C.F.R. § 223.16.
23. Transactions between Member Banks, supra note 4, discussion of general purpose credit cards.
24. 12 C.F.R. § 223.4.
transactions with another depository institution if the bank controls 80% or more of the voting securities of the institution or with an institution that controls 80% or more of the bank;

- transactions between a bank and a depository institution if the same company has 80% or more control of both institutions (the “sister bank” exemption);

- purchases of a loan by a bank from an affiliate on a nonrecourse basis; and

- purchase of assets from an affiliate and other transactions in connection with certain internal corporate reorganizations.

**Sister Bank Transactions.** Banks that are owned 80% or more by a company—often referred to as “sister banks”—are affiliates for the purposes of Section 23A, but benefit from an exemption from the qualitative and collateral value requirements shown above. As indicated, that leaves them, however, subject to the prohibition on the purchase of low-quality assets and to the commandment as to safety and soundness. Interestingly, because operating subsidiaries are treated as being part of the banks, they are also under the sister bank exemption and may engage in covered transactions with each other. It is noteworthy that banks that are commonly controlled but with ownership at less than 80% are just plain affiliates, subject to all the rules.

**Purchase of Securities.** While purchases of securities from an affiliate are covered transactions, Regulation W recognizes that certain transactions can be objectively priced on an arm's length basis. These transactions are exempt from the quantitative limits, the collateral requirements, and the low-quality assets prohibition. First in this regard, purchases from an affiliate of securities or other assets at or below their market value are exempt if the securities are listed on an exchange or whose market value is otherwise “readily identifiable and publicly available.” In addition, securities purchased from an affiliate that is a registered broker-dealer are exempt if the securities conform to the Securities and Exchange Commission (“SEC”) criteria for having a “ready market” and the securities:

- are not issued by an affiliate;
- are not purchased within 30 days of an underwriting by an affiliate (except for certain U.S. and U.S.-guaranteed obligations);

25. 12 C.F.R. § 223.41.
26. 12 C.F.R. § 223.42.
27. SEC Rule 240.153c3-1(c)(11)(i) defines a “ready market” as a “recognized securities market in which there exits independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price.”
• are eligible for purchase by state member banks;
• are not low quality; and
• meet other requirements including having their prices quoted on an unaffiliated electronic service that provides data from real-time financial networks.

Other Exemptions. Other activities that are exempt from the above provisions of Section 23A include:

• making deposits in correspondent banks;
• making a loan to, or issuing a guarantee on behalf of, an affiliate that is fully secured by U.S. obligations or a segregated, earmarked deposit account at the member bank (this one is particularly useful, permitting an affiliate to convey control of a securities account or deposit account to the bank with sufficient collateral to cover any covered transaction);
• purchasing an extension of credit from an affiliate on a nonrecourse basis subject to certain limits including the following: (i) the bank must make an independent evaluation of the borrower's creditworthiness before the loan is made, and (ii) the bank may not purchase each year more than 50% of the loans originated by the affiliate (historically called the “250-250 exception” because of its previous citation);
• purchasing a security from a securities affiliate of the member bank if the member bank or the securities affiliate is acting exclusively as a riskless principal, and the security purchased is not issued, underwritten, or sold as principal (other than as riskless principal) by any affiliate of the member bank;
• purchasing from an affiliate a loan originated by the bank and sold to the affiliate subject to a repurchase agreement or with recourse; and
• extensions of intraday credit to an affiliate if the bank maintains policies and procedures reasonably designed to manage the credit exposure of these transactions, the transactions comply with the “arm's length” requirements of Section 23B, and the bank ceases to treat the transaction as an extension of intraday credit at the end of the bank's business day in the United States.

Basic Provisions of Section 23B
Section 23B was added in order to assure that affiliates did not have sweetheart deals with banks and their subsidiaries. As a result, it sweeps

more broadly in terms of the transactions that it covers. For purposes of Section 23B, the terms “subsidiary” and “affiliate” have the same meaning as in Section 23A except the term “affiliate” does not include an insured depository institution.

**Market Terms Requirement.** 29 Section 23B requires that certain transactions between a bank and its affiliates be on “market terms,” that is, on terms including credit standards that are prevailing at the time for comparable transactions, or in the absence of comparable transactions, on terms that in good faith would be offered to nonaffiliated companies. This means that banks must either find comparables for the transaction or validate that the terms would be offered to unaffiliated parties. It also means that banks and their affiliates need to have arms-length, negotiated contracts in place for the transactions to which Section 23B applies.

The market terms requirement applies to all transactions that are “covered transactions” under Section 23A, with certain exceptions: 30

- making deposits in correspondent banks;
- making a loan to, or issuing a guarantee on behalf of, an affiliate that is fully secured by U.S. obligations or a segregated, earmarked deposit account at the bank;
- purchasing “marketable securities” from an affiliate and purchasing loans from an affiliate subject to a repurchase agreement;
- transactions between banks in which one has 80% control of the other;
- transactions between sister banks; and
- purchasing loans on a nonrecourse basis from an affiliated depository institution.

Furthermore, the requirement applies to the following transactions that are not “covered transactions” under Section 23A:

- payments of money or furnishing services to an affiliate;
- transactions in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person; and
- transactions with a third party if an affiliate has a financial interest in the third party or is a participant in the transaction.

**Prohibited Asset Purchases.** 31 A bank or its subsidiary may not purchase as fiduciary any securities (as defined in Section 3(a)(10) of the

29. 12 C.F.R. § 223.51.
30. 12 C.F.R. § 223.52.
31. 12 C.F.R. § 223.53.
Securities Exchange Act of 1934 from an affiliate unless the purchase is permitted: (i) under the instrument creating the fiduciary relationship, (ii) by court order, or (iii) by the law of the jurisdiction governing the fiduciary relationship.

Banks either acting as principal or fiduciary are also prohibited from purchasing or otherwise acquiring any security during the existence of any underwriting or selling syndicate, if a principal underwriter of that security is an affiliate of such bank, unless: (i) the purchase was approved, before the securities were initially offered for sale to the public, by a majority of the directors of the bank; and (ii) the approval was based on a determination that the purchase is a sound investment for the bank irrespective of the fact that an affiliate of the bank is the principal underwriter.

Advertising Rules. A bank or any subsidiary or affiliate of a bank may not publish any advertisement or enter into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates. This provision, however, does not prohibit a bank from issuing a guarantee, acceptance, or letter of credit on behalf of an affiliate, confirming a letter of credit, or entering into a cross-affiliate netting arrangement, to the extent the transaction satisfies the quantitative limits and collateral requirements of Section 23A.

**Examples:**

Several simple transactions between a bank and the other members of the bank holding company family will be subject to the quantitative limitations and collateral requirements of Section 23A and the additional requirements of Section 23B:

**Loan to Holding Company:** If a subsidiary bank makes a loan to a holding company subsidiary, this transaction will fall within the category of “covered transactions.” As a covered transaction, the bank would be subject to the quantitative limitations of Section 23A and the applicable restrictions of Section 23B. Further, since the loan is an extension of credit to an affiliate requiring collateral security, the transaction will be subject to the collateral requirements of Section 23A.

**Holding Company Stock as Collateral for Bank Loan:** If a customer of a subsidiary bank offers stock of a holding company to secure a loan from the subsidiary bank, this transaction will also fall within the category of “covered transactions.” Since this transaction does not create a repayment obligation of an affiliate, the bank will not be subject to

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33. 12 C.F.R. § 223.54.
the collateral requirements of Section 23A, but will be subject to the quantitative limitations of Section 23A and the applicable restrictions of Section 23B. The affiliate for these purposes is the issuer of the stock—the holding company.

**Bank Lease of Property from Holding Company:** If a subsidiary bank leases property from a holding company, this transaction will not fall within the definition of “covered transactions,” and the bank will not be subject to the limitations or requirements of Section 23A. However, as this transaction is one of the specified transactions under Section 23B, the lease must be on comparable terms as leases offered to nonaffiliates and it must comply with the other applicable restrictions of Section 23B.

**Bank Loan of Operating Funds to Its Insurance Agency Subsidiary:** A nonbank subsidiary of a bank engaged in insurance sales is excluded from the definition of “affiliate” by Regulation Y, even if it is a financial subsidiary otherwise. Therefore, neither the quantitative nor qualitative restrictions of Section 23A nor the additional restrictions of Section 23B would apply to a bank loan to its nonbank subsidiary.

**Insider Loans**

Sections 22(g) and 22(h) of the Federal Reserve Act (“FRA”)\(^{34}\) impose restrictions on extensions of credit a bank may make to the bank’s directors, executive officers, and principal stockholders. These restrictions also apply, with certain exceptions, to persons who hold these insider positions in the bank’s affiliates.\(^{35}\) Subsidiaries of banks are considered part of the bank itself under this law, as with Sections 23A and B. As a result, extensions of credit by bank subsidiaries to the bank’s insiders are counted as loans made by the bank for purposes of the insider lending restrictions.

The Federal Reserve’s insider loan rules are implemented by Regulation O.\(^{36}\) As it did with the FRA’s provisions on transactions with affiliates, Congress extended the FRA sections on insider loans to state

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34. 12 U.S.C. Section 375a and 375b, respectively.
35. Affiliates include any parent company of the bank and any subsidiary of the parent company that represents 10% or more of the consolidated assets of the parent company.
nonmember banks and savings associations. Regulation O also applies to credit card banks, industrial loan companies (“ILCs”), and certain other institutions that are excluded from the definition of “bank” under the Bank Holding Company Act (“BHCA”) and to the companies that control these institutions.

**Principal Provisions of Regulation O**

Regulation O applies to insiders, which are defined with the following permutations:

- **Insiders** are defined as directors, executive officers, and principal shareholders. Regulation O imposes limits not only on extensions of credit the bank may make to its own insiders but also, with some exceptions, on extensions of credit to persons who are insiders of the bank's subsidiaries, parent company, if any, and subsidiaries of the parent company.

- **Directors**. This term is given its normal meaning; Regulation O provides that a person’s status as a director is not dependent on the person receiving compensation for his or her service. Advisory directors who are unelected, who do not vote and are not authorized to vote on matters before the board of directors, and who provide solely general policy advice are not “directors” for purposes of Regulation O.

- **Executive officers**. Executive officers of a company or bank are persons who participate or have authority to participate (other than in the capacity of a director) in major policymaking functions of the company or bank regardless of their title. It should be noted, however, that there are certain officer positions that are presumed under Regulation O to be executive officer positions, including:

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37. These rules are applied to state nonmember banks by Section 18(j) of the Federal Deposit Insurance Act (FDIA) (12 U.S.C. § 1828(j)). Section 22(h) of the FRA, which deals with loans to all insiders and executive officers, was applied to state nonmember banks in 1978 by Section 108 of Pub. Law 95-630 (Nov. 10, 1978), 92 Stat. 3664. Section 22(g), relating to loans to executive officers, was added to Section 18(j) by Section 306(k) of FIDICIA, Pub. Law 102-242, Dec. 19, 1991, 105 Stat. 2236. Insider loan rules are applied to savings associations by Section 11(b) of the Home Owners’ Loan Act (HOLA) (12 U.S.C. § 1468(b)). Section 22(h) of the FRA was applied to savings associations by Section 301 of FIRREA. Regulation O now applies to savings associations. See 12 C.F.R. § 163.43.

38. 12 U.S.C. § 1811, et seq. Credit card banks and ILCs are excluded from this definition by Sec. 2(c)(2)(F) and (H), respectively, of the BHCA and are discussed in Chapter 9, infra.

39. Subsidiaries of a parent company that represent less than 10% of the consolidated assets of the parent company are generally excluded from coverage under Regulation O.
chairman of the board;
- president;
- vice president;
- secretary;
- treasurer; or
- cashier.

The above-mentioned officers will be considered “executive officers” for purposes of Regulation O, unless (i) the officer is excluded by resolution of the board of directors or by the bylaws of the entity, from participating (other than as a director) in major policymaking functions of the entity; and (ii) the person does not in fact participate in them.

Board resolutions excluding an individual from the designation of “executive officer” will only pass regulatory muster if the person may not participate in major policymaking functions, and in fact, does not participate in major policy making functions. The terms “authority to participate” and “major policymaking functions” are not defined by Regulation O. However, when considering whether an individual is an “executive officer” for purposes of Regulation O, banking regulators may determine on a case-by-case basis whether an individual is responsible for the formulation and implementation of major policy. Regulators have a fair amount of discretion in determining the types of duties that constitute major policymaking functions, but have often focused on involvement in areas of key importance for a banking institution, such as lending, audit, investments and trust activities. There tends to be a heavy regulatory presumption against excluding certain officers from the designation of executive officer, including: (i) any officer whose title contains the word “Chief;” and (ii) the chairman of the board.

Principal Shareholders. These are persons other than banks (and any company that controls the bank) that, directly or indirectly, or acting through or in concert with others, own or control the power to vote more than 10% of any class of voting shares of a bank or company. For purposes of determining whether an individual is a principal shareholder for purposes of Regulation O, shares owned or controlled by a member of a person’s “immediate family” are considered to be held by that person. “Immediate family” includes the spouse of an individual, the individual’s minor children and any of the individual’s children (including adults) residing in the individual’s home. Additionally, an individual may be deemed to be a principal shareholder if the individual is “acting in concert” with other shareholders, and the aggregate holdings of the group acting in concert exceed the 10% ownership threshold. Federal Reserve Regulation Y establishes various presumptions of concerted action that are applicable to a determination of acting in concert under Regulation O.

Related Interests. Regulation O covers extensions of credit to insiders and to their “related interests.” These are businesses and other companies
controlled by the insider and political or campaign committees that are controlled by an insider or that provide funds or services that benefit the insider. Regulation O establishes a conclusive presumption of control triggered by: (i) ownership of 25% or more of a class of the voting securities of an entity; (ii) control in any manner over the election of a majority of the directors of the company; or (iii) the ability to exercise a controlling influence over the management or policies of the company (regardless of the individual’s percentage ownership interest in the company). Regulation O establishes rebuttable presumptions of control triggered by ownership of between 10% and 25% of any class of the company’s voting securities if the individual either: (i) is an executive officer or director of the company; or (ii) is the company’s single largest holder of the company’s voting securities.

**Loan Limits**

An “extension of credit” is defined broadly under Regulation O to include virtually any transaction as a result of which a person becomes obligated to pay money or its equivalent to a bank. This includes not only loans and lines of credit, but also certain advances of unearned salary, overdraft advances, certain standby letters of credit, and more. Moreover, the Dodd-Frank Act expanded the definition of “extension of credit” to include credit exposure to a person from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction.

There are four sets of overlapping loan limits in Regulation O:

- loans to all insiders that require prior approval;
- separate rules on loans to executive officers of the bank;
- a ceiling on the aggregate amount of loans a bank may have outstanding to all insiders at any one time; and
- a limit on the maximum amount of loans that may be outstanding to a single borrower.

Loans to insiders of the bank, its subsidiaries, and certain affiliates (except loans to executive officers of the bank) and loans to the related interests of those insiders, require prior approval of a majority of the entire bank’s board of directors (with any interested director recusing themselves from discussion and abstaining from the vote) if, when combined with all other outstanding loans from the bank to that person and the person’s related interests, they would exceed either: the greater of $25,000 or 5% of

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40. Overdraft advances by executive officers and directors of a bank are subject to separate and distinct restrictions set forth in 12 C.F.R. § 215.4(e).
the bank's unimpaired capital and unimpaired surplus;\textsuperscript{41} or $500,000. Prior board approval is not required if the loan is made pursuant to a line of credit approved by the board within 14 months of the loan.

**Bank Executive Officer “Carve Out.”** Separate rules apply to extensions of credit to executive officers of the bank. These rules permit the following extensions of credit, subject to the bank’s normal underwriting standards:

- Loans “in any amount” to executive officers for financing, subject to certain restrictions, the purchase, construction, or rehabilitation of their principal residence, for education of their children, and loans secured by certain interests in securities or by a segregated account.\textsuperscript{42} The phrase “in any amount” in Regulation O means that the loans can be for any amount up to the loans to one borrower limit summarized below, so long as the loan is made on a non-preferential basis and the executive officer meets the bank’s underwriting standards for the loan.
- Loans for “other purposes,” which may not exceed at any one time the higher of 2.5% of the bank’s unimpaired capital and unimpaired surplus or $25,000, but in no event more than $100,000.

**Maximum Loan to One Borrower.** Regulation O provides that the maximum extension of credit that may be outstanding by a member bank to any one insider and his or her related interests is the loans to one borrower (“LTOB”) limit that is applied to national banks by Section 5200 of the Revised Statutes.\textsuperscript{43} This limit is:

- 15% of the bank’s unimpaired capital and surplus for extensions of credit not fully secured; plus
- an additional 10% of the bank’s unimpaired capital and unimpaired surplus in the case of extensions of credit that are fully secured by readily marketable collateral.

For state member banks chartered in a state that has a LTOB limit lower than that provided in Section 5200, the lower rate will prevail. Additional requirements and restrictions apply to overdrafts of directors and executive officers of member banks.\textsuperscript{44}

\textsuperscript{41} A bank’s unimpaired capital and unimpaired surplus equals the bank’s Tier 1 and Tier 2 capital plus the balance of the bank’s allowance for loan and lease losses not included in its Tier 2 capital for regulatory reporting purposes.

\textsuperscript{42} Restrictions and parameters for these types of loans are set forth in 12 C.F.R. § 215.5(c)(2) and (c)(3).

\textsuperscript{43} 12 U.S.C. § 84. See discussion below.

\textsuperscript{44} 12 C.F.R. § 215.4(e).
Exclusion of Directors and Officers of Affiliates. Extensions of credit to directors and executive officers of an affiliate are not subject to the above general loan limits if: (i) the director or executive officer is excluded by a provision in the bank’s bylaws or resolution of its board of directors from participating in (and the director or officer in fact does not participate in) major policymaking functions of the bank; (ii) the affiliate does not control the bank; and (iii) the assets of the affiliate do not constitute more than 10% of the consolidated assets of the company that controls the bank.

Aggregate Loan Limit
Section 22(h) provides that, subject to certain exceptions, the aggregate amount of extensions of credit outstanding to all insiders may not exceed the bank’s unimpaired capital and unimpaired surplus. Banks with deposits of less than $100 million that are well-managed and well-capitalized may have up to twice that amount if authorized by an annual resolution of the bank’s board of directors, which must determine, among other things, that the higher limit is consistent with safe and sound banking practices.

Recordkeeping Requirements
Recordkeeping for Insiders of the Bank. Regulation O requires banks to adopt recordkeeping methods that:

- identify, through an annual survey, all insiders of the bank; and
- maintain records of all extensions of credit to insiders of the bank itself, including the amount and terms of each such extension of credit.

Recordkeeping for Insiders of Affiliates. Regulation O has also required banks to identify all directors, officers, and principal shareholders of the bank and its affiliates and their related interests and to specify the amounts and terms of all credit extended to these insiders. By the time the Federal Reserve Board considered adoption of amendments to Regulation O in 1994, it was obvious that financial institution holding companies had become so large and widely dispersed that literal compliance with these requirements was not practical. The Federal Reserve realized that large banking organizations with “hundreds of affiliates with thousands of officers and directors would have no practical way to know who they are or

45.  *Id. See also, 12 C.F.R. § 215.4(d).*
46.  *12 C.F.R. § 215.4(d)(2).*
47.  *12 C.F.R. § 215.8(b).*
whether they have a loan with the bank” and adopted an amendment to Regulation O permitting banks to use one of the three following methods to make these reports:

- **Survey method.** Identifying each insider of the bank’s affiliates through an annual survey and keeping records of extensions of credit made to these insiders;
- **Borrower inquiry method.** Requiring as part of each extension of credit that the borrower indicate whether the borrower is an insider of an affiliate of the bank, and maintaining records that identify the amount and terms of each extension of credit by the bank to borrowers so identifying themselves; or
- **Alternative recordkeeping method.** As approved by the banks’ principal federal regulator.  

**Other Reports**

Upon receipt of a written request from a member of the public, a bank must disclose the names of its executive officers and principal shareholders who, along with their related interests, received extensions of credit from the bank as of the latest previous quarter of the year, that in the aggregate equaled or exceeded 5% of the bank’s capital and unimpaired surplus or $500,000, whichever amount is less. Additionally, each executive officer or director of a bank that is not publicly traded must report annually to the board of directors the outstanding amount of any extension of credit that is secured by the stock of the bank.

**Purchases of Assets from Insiders**

Section 615 of the Dodd-Frank Act extends the protections afforded by Regulation O by adding a section prohibiting an insured depository institution from purchasing an asset from an “insider” unless: the transaction is on market terms; and, if it represents more than 10% of the capital of the bank, it is approved in advance by a majority of the disinterested members of the board of directors. The rule became effective on July 21, 2011.

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49. 12 C.F.R. § 215.8(c).
50. 12 C.F.R. § 215.9(b).
51. 12 C.F.R. § 215.10.
52. Amending Section 18 of the FDIA (12 U.S.C. § 2828) by adding a subsection (z).
Loans to One Borrower

The oldest form of prudential regulation governs how much a bank may lend to one borrower. The “lending limit” or “loans to one borrower” (LTOB) limit is intended to assure that no concentration of credit exists such that one borrower could cause the failure of the bank. It also promotes diversification of the loan portfolio. The lending limit for national banks is codified at 12 U.S.C. § 84 (Section 5200 of the Revised Statutes), with the OCC regulations at 12 C.F.R. Part 32. The OCC published an Interim Final Rule on June 21, 2012, in order to amend its regulation to consolidate the lending limit rules applicable to national banks and savings associations and remove its separate regulation governing lending limits for savings associations. Thus, the OCC rules apply to federal savings associations from July 21, 2012, forward. Note: the banking agencies also supervise concentrations at banks, and that is different from LTOB. A concentration could be numerous loans to one industry or in one segment (e.g., commercial loans) and the agencies have issued various guidelines, usually under the rubric of safety and soundness, with respect to concentrations of credit.

The lending limit for national banks and federal savings associations is 15% of the institution's capital and surplus (defined in the same manner as for Regulation W and Regulation O), plus an additional 10% of the institution's capital and surplus if the loan is fully secured by readily marketable collateral (the “general lending limit”). Readily marketable collateral is narrowly defined to include financial instruments (securities traded on a national exchange, commercial paper, negotiated certificates of deposit, and shares of mutual funds) and bullion that are salable under ordinary market conditions with reasonable promptness at a fair value determined by quotations based on actual transactions at an auction or similarly available daily bid and ask price markets.

In addition, loans made by a national bank to a corporate group may not, in the aggregate, exceed 50% of the lending bank's capital and surplus. This 50% limitation applies even if loans to some or all of the members of the corporate group are not required to be combined for purposes of the general lending limit. OCC regulations define a corporate group as consisting of a person or entity and all other entities in which such person or entity owns 50% or more of the voting securities or voting interests.

State banks and state savings associations are subject to similar provisions under state law, although they tend to be less stringent. The regulations of the OCC include provisions that address, in part, this lending

55. 12 C.F.R. § 32.2(n).
56. 12 C.F.R. § 32.5(d).
limit disparity between national banks and state-chartered banks in states that have higher lending limits than national banks. Under the OCC lending limit regulations, an eligible national bank is able (subject to receipt of prior OCC approval) to increase its lending limit with respect to one-to-four-family residential real estate loans, loans to small businesses, and certain agricultural loans by an amount equal to the lesser of (i) 10% of its capital and surplus or (ii) the percent of its capital and surplus, in excess of 15%, that a state-chartered bank is permitted to lend under the applicable laws of the state in which the national bank's main office is located (the “increased lending limits”). A national bank's outstanding loans to any one borrower made under the increased lending limits, when aggregated with loans made to the same borrower under the OCC's general lending limit, may not exceed 25% of the lending bank's capital and surplus. Further, a national bank's total outstanding loans to all borrowers made under the increased lending limits may not exceed 100% of the bank's capital and surplus.

**Extensions of Credit**

Lending limits apply to a vast assortment of transactions defined generally as “loans or extensions of credit”:

- a contractual commitment to advance funds
- purchase of securities subject to repurchase; exception for government securities where a bank has assured control over the collateral
- purchase of third-party paper subject to repurchase
- overdrafts, whether prearranged or not, but not intraday
- charged off loans, unless unenforceable
- Fed funds sold with a maturity of more than one day
- guarantee fund and initial margin to a clearing house.

The OCC also implemented Section 610 of the Dodd-Frank Act, to amend the statutory definition of “loans and extensions of credit” to include credit exposures arising from derivative transactions, repurchase agreements, reverse repurchase agreements, securities lending transactions, and securities borrowing transactions, effective on January 1, 2013.

The following are NOT loans or extensions of credit:

- additional advances for taxes, insurance, utilities to preserve the value of the collateral of the bank
- financed sale of a bank’s own assets

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57. 12 C.F.R. § 32.7.
58. 12 C.F.R. § 32.2(k)(1).
accrued interest
• renewal or restructured loans if no new money or new borrower
• nonrecourse participation where credit risk is shared
• commercial letters of credit, not standby or commitments.\(^\text{60}\)

In addition, there are numerous exceptions, including:
• loans secured by U.S. obligations or those guaranteed by a federal agency
• loans to or guaranteed by the general obligations of a state or political subdivision loans secured by segregated deposit accounts
• loans secured by discount of commercial paper
• 35% limit for loans secured by bills of lading or warehouse receipts covering readily marketable staples
• loans participated without recourse to the originating bank—do not count the amount of participations.

**Attribution Rules**
What makes lending limit law more difficult is that “one borrower” is much broader in practice than one individual or one company. Section 84(d)(2) provides authority to the OCC to determine when a loan putatively made to one person shall be attributable to another person. The regulations of the OCC\(^\text{61}\) require a loan to a named borrower to be attributed to other borrower(s) under a direct benefit test and a common enterprise test:

- If the named borrower is a partnership, joint venture, or association, the loan will be attributed to the partners or members of the entity unless: (i) the agreement establishing the partnership, joint venture, or association provides that the members of the entity are not personally liable for the obligations of the entity; and (ii) those provisions of the agreement are valid under applicable law.
- A loan to a named borrower will be attributed to the other borrower(s) if: (i) the proceeds of the loan, or assets purchased with loan proceeds, are transferred to the other borrower(s), other than in a bona fide arm’s-length transaction where the proceeds are used to acquire goods, property, or services; or (ii) a common enterprise exists between the named borrower and the other borrower(s).
- A common enterprise will be found to exist if:
  - the expected source of repayment for loans made to both the named borrower and the other borrower(s) are the same and

\(^{60}\) 12 C.F.R. § 32.2(k)(2).
\(^{61}\) 12 C.F.R. § 32.5.
no borrower has another source of income from which the loan and the borrower's other obligations can be repaid;

- the named borrower and the other borrower(s) are related through common control\(^\text{62}\) and there is substantial financial interdependence between the borrowers;\(^\text{63}\)
- the named borrower and the other borrower(s) use the loan proceeds to acquire more than 50% of a business enterprise, without regard to whether each borrower is otherwise creditworthy independently of either the business enterprise or the other borrower(s); or

- the OCC determines that a common enterprise exists based on the facts and circumstances of a particular transaction.\(^\text{64}\)

National banks would generally be required to combine loans to separate borrowers when the source of repayment for the loans is the same, the creditworthiness of the named borrower would not justify the loan without reliance on the creditworthiness of the other borrower(s), or the primary beneficiary of the loan was the other borrower(s) rather than the named borrower.

**Noncompliant and Nonconforming Loans**

When a bank makes a loan that is “overline,” i.e., over the lending limit when it is made, the board of directors is deemed to be personally responsible for the loan until the last penny is paid.\(^\text{65}\) That is pretty sobering news to any client and is a very effective prophylactic to assure compliance.

\(^{62}\) For purposes of the OCC's lending limit rules, control is presumed to exist when a person or entity, directly or indirectly, or acting through or together with one or more persons or entities: (i) owns, controls, or has the power to vote 25% or more of the voting securities of an entity; (ii) controls in any manner the election of a majority of an entity's directors, trustees, or persons exercising similar functions; or (iii) has the power to exercise a controlling influence over the management and policies of an entity.

\(^{63}\) "Substantial financial interdependence" is deemed to exist if 50% or more of the annual gross receipts or gross expenditures of one borrower are derived from transactions with another person or entity.

\(^{64}\) Factors that have been considered by the OCC in making such a determination include whether the borrowers: (i) engage in supporting lines of business; (ii) interchange goods and services; (iii) share common ownership of assets, common management, or use of common facilities; (iv) commingle assets and liabilities; (v) engage in closely related business activities; (vi) have similar structures, financing, and holdings; (vii) may receive financial aid from each other; (viii) are members of the same family; and (ix) pledge assets to support another's loans.

\(^{65}\) del Junco v. Conover, aff'd, 682 F2d 1338 (9th Cir. 1982). This policy has now been codified in the FDIA, permitting the banking agencies to seek restitution form directors for violations of law. See, 12 U.S.C. § 1818(b)(6).
Loans are deemed nonconforming if they later exceed the lending limit. However, no remedy is required if they complied with limits when made, for instance, when: capital of the bank declines, regulators alter the capital rules so that capital levels decline and two borrowers merge. However, if the collateral value declines, the borrower must post more collateral within 30 days.

**Interplay among Prudential Regulations**

There are numerous situations in which a given loan may be subject to the lending limit, as well as Regulation W and/or Regulation O. In addition, a bank may buy debt of a customer that is subject to different rules under investment limitations in 12 U.S.C. Section 24 (Seventh) and 12 C.F.R. Part 1. How are these reconciled? According to the OCC, the lending limit does not apply to covered transactions with affiliates; it does apply to Regulation O loans; and the investment limits provide additional leeway such that a bank may invest in debt up to the limit in Section 24 (Seventh) and 12 C.F.R. Part 1 (10%) and loan that borrower up to the lending limit.\(^6\)  

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66. 12 C.F.R. § 32.1(c)(1)-(3).