Affiliate Restrictions Considerations for Non-Banks Converting to, or Acquiring, a Bank

Executive Summary

Many non-banks consider acquiring a bank (or establishing a de novo bank) to serve their customers and capture benefits afforded to a bank. Before embarking on this strategy, one dimension that should be well understood are the regulatory limitations applied to the affiliated businesses of an institution, or investors, which owns a bank. Our overview is not a comprehensive review of these restrictions, nor a substitution for legal advice. However, given the importance of these restrictions, we believe a general overview is necessary, and provides a good foundation for more detailed discussions with attorneys intimately acquainted with banking laws.

Reg W limits transactions between a bank and its affiliates. Any company or individual within the same corporate family or under common control is deemed an affiliate. Restrictions include limits on lending, payments, and other transactions between a bank and its affiliates. Furthermore, affiliates will face heightened risk and compliance requirements. Myriad regulations, administration costs, and compliance with changes to the rules (usually brought about by a crisis) can impact a strategic plan. Regulation W is one of these obstacles that needs to be well understood. When considering transactions with affiliates, including lending to an affiliate, a bank must first take into account what is in the best interest of the depositors - not customers, shareholders, or employees.

Non-banks can capture the value of providing financial services directly by acquiring, or converting to, a bank. A non-bank that can transfer loan receivables to a bank (e.g. the loan pipeline of a mortgage bank or loans made by a non-bank finance company) can shift these assets to the bank and benefit from a lower cost of funds. Payments business – wires, ACH, debit card, credit card – can flow through the bank, ensuring fees remain in the consolidated group. Intercompany derivatives, management fees, leases, or other transactions can be used to obtain financial benefits for the group. For some businesses, the benefits of bringing banking services in-house more than cover the cost of tighter risk and compliance controls.

Many banks opt to not lend to affiliates, but in the rare case that they do, loans to affiliates are capped at 10% of the bank's capital. Payments business that runs through the bank must be subject to the same service level agreements and pricing as non-affiliated customers. The same is true for derivatives and other transactions – these are allowed but only on market terms for similar transactions, and this must be well documented.

Risk and Compliance

Limitations on transactions with affiliates are designed to limit risk at the bank. Regulation W was promulgated by the Federal Reserve in 2003 to implement Sections 23A and 23B of the Federal Reserve Act. These sections establish a unique set of requirements and limitations on transactions between member banks and their nonbank affiliates to prevent:

1) losses to the bank that arise from transactions between it and its nonbank affiliates and
2) the transferring to the nonbank affiliate any of the bank's benefits derived through their access to the federal deposit insurance safety net.

Implementation of Reg W can be complex because it covers transactions throughout the affiliated organization. Reg W is conceptually straightforward; however, implementation can be more challenging, especially for larger organizations as organizational complexity increases. In response to the number of Reg W exceptions authorized during the financial crisis, regulatory complexity became more challenging with the Dodd-Frank Act.

Reg W has both quantitative and qualitative limits as discussed above. Requirements imposed by Reg W on banks and affiliates include quantitative limits per affiliate and in aggregate; qualitative limits on the types of assets that can be purchased from affiliates; collateral requirements; requirements that transactions be on terms that are consistent with safe and sound banking practices; and requirements that pricing be at "arms-length terms."

Bank compliance requirements can be daunting for non-banks. In addition to the legal advice needed, the bank's risk, compliance, and operational teams ultimately need to have programs in place to ensure adherence to the regulation. The key areas of focus include:

- Development and integration of an enterprise-wide compliance program
- Structured corporate governance to ensure accountability
- Creation of and maintenance of a complete Reg W information repository
- Implementation of a complete set of controls, testing, and compliance reporting processes

With FinTech firms, mortgage companies, insurance companies, and others exploring expansion into the banking realm, Reg W needs to be understood, managed, and risks mitigated in the context of the unique circumstances, products, and service offerings.

Extensions of Credit

The extension of credit to an affiliate including loans, letters of credit, and guarantees is governed by Regulation W ("Reg W"). Section 23 A of the Federal Reserve Act is the primary statue governing transactions between affiliates, including lending. The guiding principle of the regulatory principle and policy restrictions of Reg W is to protect the depositors of member banks, and the deposits insured by the FDIC, from actions and activities of affiliates that are not FDIC insured.

Covered Transactions Under 23A:

- loans and extensions of credit to an affiliate,
- investments in an affiliate,

- purchase of assets from an affiliate, and,
- transactions that can put a bank at risk by an affiliate.

Section 23A prohibits a bank from entering into a Covered Transaction if the transaction would exceed 10% of the bank's capital stock and surplus, or the aggregate amount of the bank's covered transactions with all affiliates would exceed 10% of the bank's capital stock and surplus.

Lending and all extensions of credit to an affiliate and acceptances issued on behalf of an affiliate (credit transactions) must be secured by a statutorily defined amount of collateral, ranging from 100% to 130% of the covered transaction amount. Securities issued by an affiliate and low-quality assets are not acceptable collateral for any credit transaction with an affiliate.

Of critical importance is Section 23B that requires certain transactions, including all covered transactions, be on market terms and conditions ("Market Terms Requirement").

Lending and all extensions of credit to a customer of an affiliate is acceptable. But customer, transaction type, risk, and profitability must meet the existing standards and policies of the bank. Profitability, revenue, and relationship implications derived from the affiliate cannot be considered. All decisions must be on both market terms and an arm's length basis.

Payments Transactions

Payments transactions and flows between the bank and the affiliates are also subject to Reg W. The flow and processing of deposited items and outgoing payments between affiliates and the parent company need additional scrutiny in two areas:

1) Service levels
2) Pricing

The first issue are service-level agreements (SLA) between the bank and the affiliates as related to the processing of deposits and payments. SLAs must be in place to document the level of service to be provided by the bank and the affiliate, respectively, and to establish the standards by which performance is measured. An SLA also establishes clear lines of accountability for both the bank and the affiliate and generally includes key performance metrics and a timeline for the resolution of issues. The strongest banks create an SLA with the affiliate to define the deposit deadlines and payment cut-off times, the availability of funds for deposited items, and the price for creating and posting payments transactions. Further, the bank-affiliate SLA must be on the same terms as SLAs with other customers. Establishing a process for identifying and reviewing the SLAs on a regular schedule will ensure the SLA is current and in alignment with services provided to external customers.

The second issue relates to pricing methodologies to support deposit and payment processing charges between affiliates and the bank. For example, several payment methods should be priced on a per-item basis to the affiliate, and pricing should be similar to the pricing the bank provides to its commercial customers. Several examples include the pricing of a wire transfer-in, a wire transfer-out, the clearing of paper checks, the clearing of remote deposit capture images, the origination of ACH transactions, the receipt of ACH transactions, and accepting or providing coin and currency to the affiliate. To be compliant with Reg W, the bank should charge fees for these payment services based on volumes of similar commercial customers. Furthermore, the Funds Availability Schedule used for inbound deposits such as cash, check deposits, and remotely deposit image items should be similar to the availability schedule provided to commercial customers. Finally, any earnings

credit provided to the affiliate for deposited balances should be similar to the earnings credit offered to commercial clients.

Derivatives, Hedging, and Other Transactions

All derivatives and other transactions between bank and affiliate must also be on market terms. Just as described above for loans and payments, all trades between the bank and its affiliates must be on the same terms that the bank would execute for a similar trade with a non-affiliated entity.

For example, in the mortgage business, the interest rate risk associated with servicing (rates down, MSR value down) moves in the opposite direction from the value of the mortgage pipeline (rates down, the value of pipeline up). Hence, servicing done by an affiliate is a natural hedge for the mortgage production of a bank. If the organization executes an interest rate swap between the bank and the affiliate, it will serve to moderate the income volatility at both entities without changing the interest rate exposure of the consolidated enterprise. Bank regulators even acknowledge that affiliates often use each other as derivative counterparties to maximize profits while still managing risk – but the swap must be executed on fair market terms (rate, collateral, credit monitoring, etc.).

Derivatives that shift default risk to the bank face the same limits as a loan. Credit derivatives or other trades can protect the affiliate from loss by transferring the risk to the bank. Guaranties are similar. Any of these types of transactions are considered "covered transactions" and, thus, are included in the same bucket as a loan to the affiliate.

Purchases of assets or transfers of businesses within the corporate family must also be on market terms. It is fairly common for banks to buy or sell loans and other assets to affiliates. Similarly, when businesses are moved, the bank must pay (or receive) fair value for them. For example, some banks transfer distressed loans or foreclosed property to an affiliate for work-out. Such transfers are allowed but must be on fair market terms. Notably, Reg W does not allow a bank to buy low-quality assets, so the distressed asset transaction cannot go the other way. Furthermore, banks can only purchase assets that fit within their charter limitations.

Affiliates may charge bank management fees provided that such fees are reasonable considering the services provided to the bank. For example, it is common for IT, HR, and other administrative services to be performed at the holding company and then allocated to all subsidiaries via a management fee. This type of arrangement is allowed but, of course, the fee must not be more than the market value of similar services if they had been provided by a third party. Furthermore, management fees should be supported by written agreements between the parties that describe the service provided and the basis for the fee charged. Affiliates can lease facilities to the bank but only at, or below, fair market rates.

Conclusion

A non-bank becoming a bank, or owning a bank, is a big deal. Obtaining regulatory approval is difficult, affiliates face several intercompany limitations, and it triggers heightened risk and compliance controls. Endurance

Advisory Partners consults with banks and other institutions to identify the value of alternative strategies. We also assist with the implementation of the systems and controls necessary to gain regulatory approval and manage the bank.

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