Regulation W
What does it all mean?

23A
Covered Transaction

23B

10/20 Limits

Earmark Deposit

Vendor Management

Sister Bank

250.250 /223.42
What does Regulation W mean?

Regulation W governs transactions between a bank and its related companies

- Prevents a bank from being harmed by its affiliates
- Bank can outsource originations, servicing, and can even benefit the affiliate, but only the bank is responsible for quantifying and controlling the Reg W exposure or risk
- Regulatory Agencies have “skin” in the game:
  - FDIC – Insures the deposits
  - FRB – “Owns” Regulation W and has final say of how the regulation is construed
  - UDFI- Charters banks in Utah and has admirably defended the industrial bank charter, which allows commercial companies to own banks (may not be subject to the Bank Holding Company Act)

****All regulatory agencies recognize that this is a risk****
Key Definitions and Considerations
Regulation W Basics

Federal Reserve Act

Regulation W implements Sections 23A and 23B of the Federal Reserve Act (member banks) & is made applicable to FDIC insured banks (non-member banks) through section 18(j) of the FDI Act

23A

Section 23A, applies to “Covered Transactions” between a bank and its “Affiliates”

23A- “Collateral requirements” for an “extension of credit”

100-130% of “covered transaction” and is dependent on type of collateral

Segregated Earmark Deposit

23A- “Quantitative Limits”

10% of cap & surplus - single affiliate

20% of cap & surplus – all affiliates

23B

Section 23B, applies to nearly all of a bank’s transactions with its “Affiliates”

Requires “Market Terms or Better”

Prohibition on Low Quality Assets
Who is an Affiliate?

Generally, an “Affiliate” is any company that is owned (even in part) or controlled by a company that owns the bank.

Affiliates are determined on a legal entity basis.

Attribution Rule
Regulation W also applies when a bank is engaged in a transaction with a non-Affiliate but where the proceeds of the transaction are transferred to or used for the benefit of the Affiliate.
What is a Covered Transaction?

A “Covered Transaction” includes the following:*

• Bank extensions of credit to an affiliate,
• Bank purchases of assets from an Affiliate, Bank guarantees of Affiliate obligations;
• Bank acceptance of Affiliate securities (e.g., stock) as collateral for a loan

*Not a complete list

Additionally, pursuant to the Attribution Rule…any transaction with non-affiliated party that benefits an “Affiliate” is a “Covered Transaction.”
Why is the Attribution Rule Challenging?

Key Considerations:
- The intent of the borrower may not be known when the loan is made (e.g. Line of Credit)
- If you have a large number of affiliates or affiliates that don’t share the same name how do you identify potential transactions

Mitigation Strategy:
- Think ahead to determine potential uses of funds (How do the funds flow?)
- Documentation is critical to mitigate risk
- Controls to help identify “Attribution:”
  - Utilize an asset filter or template to assist credit personnel to determine whether funds can possibly flow to an affiliate by analyzing the potential use and flow of funds
  - Screen parties to whom you are providing credit and then screen payments going out the door to ensure that funds are not flowing to an affiliate.

REMEMBER: Similar to UDAP, this can happen at anytime during the life cycle of a transaction, so changes affecting a credit or credits may require re-assessing controls

This rule can be very subjectively interpreted – so documentation is critical
Qualitative Limitations—must be safe and sound

Quantitative Limitations—Transactions are limited to:
10% of Capital and Surplus with one affiliate
20% of Capital and Surplus with all affiliates in the aggregate

Prohibited Transactions—generally cannot purchase low-quality assets from an Affiliate

Collateral Requirements—must be at least fully collateralized or over-collateralized depending on the type of collateral (100-130%)

23B Requirements—must satisfy 23B requirements
Section 23B – Market Terms Requirement

23B governs transactions between a bank and its affiliates (not just “Covered Transactions”)

Requires that all such transactions are:

- At arm’s length;
- On market terms (terms “at least as favorable to the bank” as comparable transactions with unrelated parties);
- Meet safety and soundness requirements of a bank; and
- Are properly documented in a contract.
Examples
Example-Simple Purchase of Asset

Scenario: ABC Bank (subsidiary of ABC Co) purchases a performing loan from Bob’s Widgets (also a wholly owned subsidiary of ABC Company)

Analysis:
- **Affiliate?**
  Yes, both Bob’s Widgets and the ABC Bank are wholly owned subsidiaries of ABC Co.
- **Covered Transaction?**
  - Yes, a purchase of an Affiliate asset is a Covered Transaction.
- **Prohibited Transaction?**
  - No, the loan is performing and not a low-quality asset.

Conclusion:
Because ABC Bank has taken Bob’s Widgets out of an existing obligation, effectively taking on risk that belonged to its Affiliate, this is considered to be a Covered Transaction subject to Regulation W restrictions and requirements.

Requirements:
- Must stay within ABC Banks 10/20 limits.
- Not an extension of credit so collateral requirements do not apply
- Must be a safe and sound transaction.
- Must comply with 23B market terms requirements.
**Scenario:** ABC Bank (a subsidiary of ABC Co) extends credit to a third party, and the funds are used to refinance a prior loan made to the borrower by another ABC Co. The ABC Co. has placed a segregated earmark deposit at ABC Bank.

**Analysis:**
- **Affiliate?**
  No, the third party borrower is not an Affiliate of ABC Bank. However, the third party loan was with another ABC Co, who is an affiliate of ABC Bank.
- **Attribution?**
  Yes, although the loan is not being made to an Affiliate, an Affiliate is receiving proceeds from the transaction, or otherwise benefiting from the transaction.
- **Covered Transaction?**
  Yes, an extension of credit is a Covered Transaction.

**Conclusion:**
Because ABC Bank has extended funds that will be used to pay down the Affiliate loan, this is a Covered Transaction and must meet Regulation W requirements. However, only the amount that is flowing to the Affiliate is a Covered Transaction, not necessarily the entire loan amount.

**Requirements:**
- Must stay within ABC Bank’s 10/20 limits. Can the limits may be avoided?
- Must be appropriately collateralized by the Affiliate. (Earmark?)
- Must comply with 23B market terms requirements.
- Must be a safe and sound transaction.
Example-Indirect Attribution

Scenario:
ABC Bank (a subsidiary of ABC Co.) extends credit of $10k to a third party borrower to purchase a vehicle from a dealer, whose inventory is financed by ABC Co.

Analysis:
- **Affiliate?**
  No, the third party borrower is not an Affiliate of ABC Bank. However; ABC Co is an affiliate of the Bank.
- **Attribution?**
  Yes, although the loan is not being made to an Affiliate, an Affiliate is benefiting from the transaction because its lien is being paid off with ABC Bank funds.
- **Covered Transaction?**
  Yes, an extension of credit is a Covered Transaction.

Conclusion:
Because ABC Bank is extending funds that benefit an Affiliate, this is a Covered Transaction and must comply with Regulation W requirements, however, the amount of the Covered Transaction is the amount that is flowing to the Affiliate, not the entire loan amount.

Requirements:
- Must stay within ABC Bank’s 10/20 limits, however, these limits may be avoided if the transaction is collateralized by a segregated earmarked affiliate deposit at ABC Bank.
- Must be appropriately collateralized
- Must comply with 23B market terms requirements.
- Must be a safe and sound transaction.
**Example-23B Transaction**

**Scenario:** ABC Bank (a subsidiary of ABC Co.) *independently* makes a decision to sell a portfolio of loans to ABC Financial (a division of ABC Co.)

**Analysis:**
- **Affiliate?**  
  Yes, ABC Financial is a division of ABC Co. In this scenario, the affiliate is ABC Co. The division is not a legal entity.
- **Covered Transaction?**  
  No, selling an asset to an Affiliate is not a Covered Transaction. In this case, ABC Bank *independently* made the decision to sell assets to an Affiliate.

**Conclusion:** 23A does not apply but 23B and its requirements do apply.

**Requirements:**
- Must meet safety and soundness requirements.
- Transaction must be at arm’s length.
- Transaction must be on market terms (terms “at least as favorable for the bank” as comparable transactions with unrelated parties).
- Transaction must be properly documented in a contract.
Other Definitions and Considerations
Earmark Deposit

“a segregated deposit account with the bank that exists for the sole purpose of securing credit transactions between the bank and its affiliates and is identified as such”.

Key considerations:

✓ Can be an omnibus account for all transactions
✓ Bank must have a perfected first priority interest in the account
✓ Earmark is a benefit
  (these transactions are exempt from “quantitative limits”)
✓ Process for determining how much deposit is necessary on a periodic basis. (Cost to depositing affiliate in placing deposit)
✓ If affiliate fails to meet its obligation to the bank, process should ensure that the bank makes itself whole on a timely basis (What are terms of agreement?)

Vendor Management

Affiliates providing services to the Bank are considered “Vendors” and all Vendor Management requirements should be taken into consideration and appropriately documented.
Section 223.42k/ 250.250 Exemption

Regulation W exempts asset purchases from the 10/20 limits and low-quality prohibitions, provided the following requirements are met:

• Each transaction is independently and individually underwritten and approved by Bank.

• Bank approves the transaction and commits to purchase it from the Affiliate prior to the Affiliate committing to the borrower; (DOCUMENTATION)

• Transaction is originated by the Affiliate (not purchased);

• Bank purchases the transaction on a non-recourse basis;

• A bank has limits on the amount of transactions it may purchase from an Affiliate in a rolling calendar year and must therefore be tracked for reporting

• The Affiliate has sufficient sources to fund and retain the transaction independent of the Bank

Beware of the Sister Bank Exemption

No transaction is exempt, if it does not meet safety/soundness requirements. The only way to prove this is to document why this is ok for the bank. Remember your sister bank will be doing the same thing, so make sure each party has appropriately documented. (even market terms or better)
Helpful job aids/articles on Regulation W

Comprehensive Overview of Regulation W

Deloitte – Reg W, Under the spotlight

Reg W – The Operational Challenges
http://fsblog.accenture.com/regulatory-insights-blog/regulation-w-the-operational-challenges/

Deloitte- Banking regulators are making Reg W a priority-So should banks
Thanks for coming, I hope this helps you get through your next Reg W Transaction!