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INTERCOMPANY TRANSACTIONS

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Overview

The financial ramifications of intercompany transactions on insured institutions can be an area of supervisory concern. Affiliate transactions can result in unnecessary credit risk to a bank or increased risk to the Federal safety net (i.e., lower cost insured deposits, the payment system, and the discount window) and can result in regulatory-assessed monetary penalties for violations of applicable laws. To limit the financial and legal risk to depository institutions, it is important for a bank to thoroughly analyze intercompany transactions and to have knowledge of applicable laws, regulations, and reporting requirements. The number of authorized affiliations and relationships among banks, nonbank financial firms, and their parent holding companies has resulted in the potential for a greater number and variety of affiliate transactions. As a result, banks face increased challenges in identifying affiliate transactions and comprehensively reviewing intercompany transactions for regulatory compliance. Following is a synopsis of the laws and regulations that govern intercompany transactions between a bank and its affiliates, as well as observed common pitfalls, standard practices, and examination tips.

Intercompany Transactions

Intercompany transactions between banks (or insured savings associations) and their affiliates are defined, with limits and other requirements, in Regulation W, which implements Sections 23A and 23B of the Federal Reserve Act: [1]

Section 23A – Imposes safeguards to protect banks from misuse of their resources in transactions with their affiliates

Section 23B – Governs transactions among bank and nonbank affiliates by requiring transactions between banks and their affiliates to be on comparable terms and conditions as transactions with non-affiliates (for instance, market terms)

Attribution Rule – Proscribes that any transaction by a bank with a third party is considered to be a transaction with an affiliate "to the extent that the proceeds of the transaction are used for the benefit of or transferred to the affiliate."

Affiliate – A parent company that controls a bank; any company that is controlled by the parent company that controls the bank; companies that share a majority of their directors, partners, or trustees with the bank or parent bank holding company; and companies under common control of common shareholders of the member bank

Chart 1 lists examples of transactions that are and are not subject to Regulation W limits and requirements.[2] This article focuses on examples that are subject to Regulation W; however, transactions not specifically governed by Section 23A still must adhere to safe-and-sound banking principles.

Chart 1

Subject to Regulation W	Potentially Exempt from Regulation W
• Making a loan or extension of credit to an affiliate • Purchasing an asset from an affiliate • Selling assets to an affiliate (23B) • Accepting as collateral or purchasing securities issued by an affiliate • Providing a guarantee or letter of credit on behalf of an affiliate • Entering into tax allocation agreements between the bank and an affiliate (23B) • Paying for or furnishing services to an affiliate that acts as an agent or broker to the bank (23B) • Contributing to a depository institution an affiliate that has outstanding liabilities • Entering into derivatives and securities financing transactions that result in credit exposure	• Making transactions between depository institutions owned by the same holding company if the company owns 80 percent or more of each depository institution • Making transactions with a depository institution if the member bank controls 80 percent or more of the voting securities of the depository institution or vice versa • Paying dividends if approved by the bank's board • Making correspondent banking deposits • Giving credit for unallocated items received in the ordinary course of business • Purchasing an extension of credit originated by an insured depository institution and sold to an affiliate, subject to repurchase or with recourse • Purchasing certain liquid assets, marketable securities, or municipal securities

1 Regulation W compiles Sections 23A and 23B restrictions, Board of Governors of the Federal Reserve System (Board) staff interpretations, and the subsequent amendments, including those related to the Gramm-Leach-Bliley Act of 1999. The Board is in the process of incorporating amendments made by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

2 The examples provided are not a comprehensive list of transactions covered and exempt from Regulation W. Refer to 12 CFR 223.3(h) for a listing of "covered transactions" and to 12 CFR 223.41 and 12 CFR 223.42 for a list of exemptions from quantitative limits and collateral requirements.

Limits and Collateral Requirements

Sections 23A and 23B are designed to reduce a bank's exposure to loss from affiliate relationships and to prevent a bank from being disadvantaged by transactions with affiliated organizations. As such, Section 23A limits the amount of intercompany transactions with any single affiliate or the aggregate of all affiliates and establish collateral requirements depending on the collateral type, as follows.

	Single Affiliate	Aggregate of Affiliates
Maximum amount of intercompany transactions as a percent of bank's capital and surplus	10%	20%
Collateral Requirements[3]		
Cash and obligations of, or guaranteed by, the U.S. or its agencies	100%	
Obligations of any state or political subdivision	110%	
Other debt instruments, including loans and other receivables	120%	
Stock, leases, or other real or personal property	130%	

The purchase of low-quality assets by a bank from an affiliate is prohibited, and certain items are not eligible collateral, including low-quality assets, securities issued by an affiliate, equity securities issued by the bank, intangible assets, and guarantees or letters of credit.

Reporting Requirements

All top-tier bank holding companies are required each quarter to complete the Federal Reserve (FR) Y-8, which is called "The Bank Holding Company Report of Insured Depository Institution's Section 23A Transactions with Affiliates." This report collects information on transactions between a bank and its affiliates that are subject to Section 23A. The FR Y-8 comprises a cover page, a declaration page, and a 14-item report page. The information is used to enhance the Federal Reserve's ability to monitor bank exposures to affiliates and to ensure Section 23A compliance.

Common Pitfalls

Examiners see a variety of violations or other issues with respect to affiliate intercompany transactions. Examples, including mitigation strategies, are provided in Chart 2 below.

Chart 2

Pitfall	Mitigation
The parent company receives an unsecured "loan" by incurring an overdraft in its checking account at the bank.	Assess service charges on the overdraft. Transaction counts against quantitative limit and must be collateralized at time of overdraft with an appropriate amount of qualifying collateral.
The subsidiary bank violates "market terms" by paying 100 percent of salaries for bank employees who provide services to the parent company or another affiliate.	Develop a management services agreement that establishes a reimbursement methodology for time and expenses spent on parent company or affiliate activities.
An unsecured extension of credit results from delays in the parent company reimbursing the bank for tax liabilities or tax credits between affiliates.	Ensure the bank, holding company, and affiliates have established an intercompany tax allocation agreement. Add clear, short timeframes to the tax allocation agreement for repayment of tax refund to the bank.
The bank violates the "market terms" requirement because the parent company or its nonbank subsidiary has a business function operating within a bank-owned building without paying rent.	Enter into a written lease agreement that specifies lease terms and rental rates comparable to local market rates, based on a documented independent assessment.
The subsidiary bank creates an uncollateralized receivable from the parent company by paying for parent company expenses related to an acquisition or capital raising efforts.	Develop a management services agreement that establishes a reimbursement methodology for expenses paid by the bank on behalf of the parent company or affiliate.
The bank violates the "market terms" requirement by transferring an asset to the holding company or affiliate at book value when an independent market valuation would otherwise support a value higher than book.	A bank and its affiliates should define a process for obtaining updated market valuations of assets to be transferred between the bank and its affiliates.

3 According to 12 CFR 223.14(b), all credit transactions must be collateralized, and a bank must maintain a security interest in the collateral that is perfected and enforceable under applicable law.

Standard Practices

Banks have an obligation to ensure intercompany transactions are conducted in adherence with established laws, regulations, and guidance. To avoid violations and extra regulatory burden, management should develop policies and procedures to ensure intercompany transactions are conducted within the established guidelines. The following practices can serve as a reference for banks in consideration of their intercompany transactions.

- Establish an oversight system and internal audit program to foster awareness, manage risk, and ensure compliance with laws and regulations. Evaluate internal controls for compliance with Regulation W and test for compliance with policies, procedures, and banking statutes.
- Ensure policies and procedures reflect applicable regulations and the organization's structure. Include things such as intercompany transaction credit limits; tax allocation agreements; management service agreements; and anti-tying policies, as applicable. Ensure policies and procedures are updated and approved by the board annually.
- Document through management service and revenue/fee sharing agreements the specific services to be provided, the methodology used to develop the fee amounts, the timing and method of payments, and the fees that will be paid between the bank and its affiliate for services provided or other expenses incurred by one entity for the other's benefit.
- Periodically review the organization's structure to identify all affiliates, including companies controlled by common shareholders and other definitions of control, and clearly define the roles and responsibilities of individuals at the parent company, subsidiary bank, and nonbank subsidiaries.
- Leverage management information systems to facilitate identification, monitoring, and reporting of intercompany transactions across the entire organization.
- Document sufficient detail to support the valuations used in the sale or transfer of assets between thea bank and its affiliates.

Examiner Expectations

Bank management is responsible for developing and implementing compliance systems necessary to manage risks associated with intercompany transactions. During routine bank examinations, examiners typically review intercompany transactions between a bank and its affiliates for regulatory compliance. Examiners focus on the extent to which a bank's risk exposure is increased by transactions with affiliates and whether the institution adequately monitors the risk through management information systems and regulatory reporting to ensure statutory compliance. Examinations also may include a review of a bank's policies and procedures, servicing agreements, payment system exposure, and transaction testing of intercompany transactions. Violations and issues will require corrective actions by bank management. These regulatory responses may range from matters requiring attention noted in the examination report to violations of law, or in some rare events, monetary penalties charged under enforcement actions, depending on the severity of the violation.

Resources

- The Board's public regulation website at www.federalreserve.gov/bankinforeg/reglisting.htm
- SR 14-6, "Addendum to the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure," available at www.federalreserve.gov/bankinforeg/srletters/sr1406.htm.
- SR 04-1, "Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization," available at www.federalreserve.gov/boarddocs/srletters/2004/sr0401.htm.
- SR 03-2, "Adoption of Regulation W Implementing Sections 23A and 23B of the Federal Reserve Act," available at www.federalreserve.gov/boarddocs/srletters/2003/sr0302.htm
- SR 00-13, "Framework for Financial Holding Company Supervision," available at www.federalreserve.gov/boarddocs/srletters/2000/SR0013.htm.
- SR 98-38, "Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure," available at www.federalreserve.gov/boarddocs/srletters/1998/SR9838.htm.
- SR 94-23, "Split-Dollar Life Insurance at State Member Banks," available at www.federalreserve.gov/boarddocs/srletters/1994/SR9423.htm
- *Commercial Bank Examination Manual – Section 4050,* available at www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf.
- *Bank Holding Company Supervision Manual – Section 2020,* available at www.federalreserve.gov/boarddocs/supmanual/bhc/2000p2.pdf.

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