of the Paperwork Reduction Act of 1995, 44 U.S.C. 3501 *et seq.*

List of Subjects in 12 CFR Part 250

Banks, banking, Federal Reserve System.

For the reasons set forth in the preamble, the Board amends 12 CFR part 250 as follows:

PART 50—MISCELLANEOUS INTERPRETATIONS

1. The authority citation for part 250 continues to read as follows:

Authority: 12 U.S.C. 78, 248(i) and 371c(f).

2. Section 250.243 is added to read as follows:

§ 250.243 Applicability of section 23A of the Federal Reserve Act to loans and extensions of credit by an insured depository institution to a nonaffiliate to enable the nonaffiliate to purchase an asset through an affiliate of the institution that is acting exclusively in an agency or brokerage capacity in the transaction.

(a) The attribution rule of section 23A of the Federal Reserve Act (12 U.S.C. 371c) provides that ''a transaction by a member bank with any person shall be deemed 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, that affiliate.'' [1] The Board has considered the question of whether a loan or extension of credit by an insured depository institution (''depository institution'') to an unaffiliated borrower who uses the proceeds of the transaction to purchase an asset through an affiliate of the institution that is acting exclusively as an agent or broker in the transaction should be subject to the attribution rule because of the limited benefit that the affiliate receives when it acts only as an agent or broker in the transaction. The Board believes that a loan by a depository institution to an unaffiliated borrower who uses the proceeds of the loan to purchase an asset through an affiliate of the institution that is acting exclusively in an agency or brokerage capacity is not covered by section 23A if the affiliate retains no portion of the loan proceeds as a fee or commission for its services.

(b) A somewhat different analysis is required when the affiliate acting as agent or broker in the transaction retains a portion of the loan proceeds as a fee or commission. In such a case, the portion of the loan not retained by the affiliate as a fee or commission still would be outside the coverage of section 23A. On the other hand, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board hereby grants an exemption from section 23A for such fees and commissions.

(c) The Board notes that this interpretation would not apply if the securities or other assets purchased by the third-party borrower through the affiliate of the depository institution were issued or underwritten by, or sold out of the inventory of, another affiliate of the depository institution. In such a case, proceeds of the loan from the depository institution would be transferred to, and used for the benefit of, the affiliate that issued, underwrote, or sold the asset on a principal basis to the third party.

(d) The Board also notes that the transactions described above (including the loan to the third-party borrower and any fee or commission paid to the affiliate of the depository institution out of the loan proceeds) would be subject to the market terms requirement of section 23B, which applies to ''any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person.'' [2]

3. Section 250.244 is added to read as follows:

§ 250.244 Exemption from section 23A of the Federal Reserve Act for certain loans and extensions of credit by an insured depository institution to a nonaffiliate to enable the nonaffiliate to purchase securities through a registered broker-dealer affiliate of the institution that is acting exclusively as riskless principal in the securities transaction.

(a) A loan or extension of credit by an insured depository institution (''depository institution'') to any person other than an affiliate of such depository institution is exempted from section 23A of the Federal Reserve Act (12 U.S.C. 371c) if—

(1) The loan or extension of credit is on terms that are consistent with safe and sound banking practices; and

(2) The proceeds of the loan or extension of credit are used to purchase a security through an affiliate of the depository institution that is a broker-dealer registered with the Securities and Exchange Commission, where

(i) The affiliate is acting exclusively as a riskless principal in the securities transaction; and

(ii) The security is not issued or underwritten by, or sold out of the inventory of, any affiliate of the depository institution.

(b) This grant of exemption is applicable to a loan or extension of credit covered by paragraph (a) of this section even if a portion of the proceeds of the loan or extension of credit is used by the borrower to pay a riskless principal mark-up to the affiliate, provided that the mark-up is substantially the same as, or lower than, those prevailing at the same time for comparable transactions with or involving other nonaffiliated companies, in accordance with section 23B of the Federal Reserve Act (12 U.S.C. 371c–1).

4. Section 250.245 is added to read as follows:

§ 250.245 Exemption from section 23A of the Federal Reserve Act for certain loans and extensions of credit by an insured depository institution to a nonaffiliate made pursuant to a preexisting line of credit.

Section 23A of the Federal Reserve Act (12 U.S.C. 371c) shall not apply to an extension of credit by an insured depository institution (''depository institution'') to any person other than an affiliate of such depository institution if—

(a) The proceeds of the loan or extension of credit are used to purchase a security from or through an affiliate of the depository institution that is a broker-dealer registered with the Securities and Exchange Commission; and

(b) The loan or extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit that was not established in contemplation of the purchase of securities from or through an affiliate of the depository institution.

By order of the Board of Governors of the Federal Reserve System, May 3, 2001.

Jennifer J. Johnson,

Secretary of the Board.

[FR Doc. 01–11607 Filed 5–10–01; 8:45 am]

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[1] 12 U.S.C. 371c(a)(2).

[2] 12 U.S.C. 371c–1(a)(2)(D).

FEDERAL RESERVE SYSTEM

12 CFR Part 250

[Miscellaneous Interpretations; Docket No. R–1104]

Application of Sections 23A and 23B of the Federal Reserve Act to Derivative Transactions With Affiliates and Intraday Extensions of Credit to Affiliates

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Interim rules with request for public comments.

SUMMARY: The Board of Governors of the Federal Reserve System is adopting on an interim basis rules to address the application of sections 23A and 23B of the Federal Reserve Act to credit exposure arising out of derivative transactions between an insured depository institution and its affiliates and intraday extensions of credit by an insured depository institution to its affiliates. The rules require institutions to adopt policies and procedures reasonably designed to monitor, manage, and control credit exposures arising out of the transactions and clarify that the transactions are subject to section 23B.

DATES: The interim rules are effective January 1, 2002. Comments must be submitted on or before August 15, 2001.

ADDRESSES: Comments should refer to Docket No. R–1104 and should be sent to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551 (or mailed electronically to regs.comments@federalreserve.gov). Comments addressed to Ms. Johnson also may be delivered to the Board's mail room between the hours of 8:45 a.m. and 5:15 p.m. weekdays and, outside of those hours, to the Board's security control room. Both the mail room and the security control room are accessible from the Eccles Building courtyard entrance, located on 20th Street, NW., between Constitution Avenue and C Street, NW. Members of the public may inspect comments in Room MP–500 of the Martin Building between 9 a.m. and 5 p.m. weekdays.

FOR FURTHER INFORMATION CONTACT: Pamela G. Nardolilli, Senior Counsel (202/452–3289), or Mark E. Van Der Weide, Counsel (202/452–2263), Legal Division; Michael G. Martinson, Associate Director (202/452–3640), or Heidi W. Richards, Assistant Director (202/452–2598), Division of Banking Supervision and Regulation; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION:

Background

Sections 23A and 23B of the Federal Reserve Act are intended to limit the risks to an insured depository institution (''institution'') from transactions with its affiliates.[1] Sections 23A and 23B also limit the ability of an institution to transfer to its affiliates the subsidy arising from the institution's access to the Federal safety net.

Section 23A achieves these goals in three major ways. First, it limits the aggregate amount of an insured depository institution's ''covered transactions'' with any single affiliate (other than a financial subsidiary of the institution) to no more than 10 percent of the institution's capital and surplus, and the aggregate amount of covered transactions with all affiliates combined (including financial subsidiaries of the institution) to no more than 20 percent of the institution's capital and surplus. Covered transactions include purchases of assets from an affiliate, extensions of credit to an affiliate, guarantees issued on behalf of an affiliate, and certain other transactions that expose an institution to an affiliate's credit or investment risk.

Second, the statute requires all covered transactions between an insured depository institution and its affiliates to be on terms and conditions that are consistent with safe and sound banking practices, and prohibits an institution from purchasing low-quality assets from its affiliates. Finally, the statute requires that an insured depository institution's extensions of credit to affiliates and guarantees issued on behalf of affiliates be appropriately secured by a statutorily defined amount of collateral.

Section 23B protects an insured depository institution by requiring that transactions between the institution and its affiliates be on market terms; that is, on terms and under circumstances that are substantially the same, or at least as favorable to the institution, as those prevailing at the time for comparable transactions with *unaffiliated* companies. The market terms requirement of section 23B applies to any covered transaction (as defined in section 23A) with an affiliate as well as a broad range of other transactions, such as a sale of securities or other assets to an affiliate and a contract for the payment of money or furnishing of services to an affiliate.

The Gramm-Leach-Bliley Act (''GLB Act'') requires the Board to adopt, by May 12, 2001, final rules under section 23A to ''address as covered transactions credit exposure arising out of derivative transactions between [insured depository institutions] and their affiliates and intraday extensions of credit by [insured depository institutions] to their affiliates.''[2] The Board is adopting the interim final rules explained below pursuant to the amendments to section 23A contained in the GLB Act.

Explanation of Interim Rules

A. Derivative Transactions

Derivative transactions between an insured depository institution and its affiliates generally arise either from the risk management needs of the institution or the affiliate. Transactions arising from the bank's needs typically arise when an institution enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract or is unable to hedge the risk directly because the institution is not authorized to hold the hedging asset. In order to manage the market risk, the institution may have an affiliate acquire the hedging asset. The institution would then do a ''bridging'' derivative transaction between itself and the affiliate maintaining the hedge.

Other derivative transactions between an insured depository institution and its affiliate are affiliate-driven. An institution's affiliate may enter into an interest-rate or foreign-exchange derivative with the institution in order to accomplish the asset-liability management goals of the affiliate. For example, an institution's holding company may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The holding company may then enter into a fixed-to-floating interest-rate swap with its subsidiary insured depository institution to reduce the holding company's interest-rate risk.

Insured depository institutions and their affiliates that seek to enter into derivative transactions for hedging (or risk-taking) purposes could enter into the desired derivatives with unaffiliated companies. Institutions and their affiliates often choose to use each other as their derivative counterparties, however, in order to maximize the profits of and manage risks within the consolidated financial group.

The Board believes that derivative transactions between an insured depository institution and an affiliate are subject to section 23B under the

[1] Section 23A originally was enacted as part of the Banking Act of 1933 and applied only to banks that were members of the Federal Reserve System. Congress amended the Federal Deposit Insurance Act in 1966 to extend section 23A to insured nonmember banks. 12 U.S.C. 1828(j). In 1989, Congress further extended the coverage of section 23A to insured savings associations. 12 U.S.C. 1468. Congress enacted section 23B of the Federal Reserve Act as part of the Competitive Equality Banking Act of 1987, and has subsequently expanded its scope to cover the same set of depository institutions as are covered by section 23A.

[2] GLB Act section 121(b)(3) (codified at 12 U.S.C. 371c(f)(3).

express terms of the statute.[3] The Board has not ruled on the question of whether derivative transactions between an insured depository institution and its affiliates are covered transactions under section 23A.

Derivative transactions between an insured depository institution and an affiliate resemble section 23A covered transactions in many respects. Such transactions may expose institutions to the credit risk of their affiliates. Although the typical institution-affiliate derivative transaction does not create current credit exposure for the institution at the inception of the transaction, an institution may incur current credit exposure to an affiliate during the term of a derivative transaction and nearly always faces some amount of potential future exposure on such a transaction. The credit exposure on a derivative transaction with an affiliate poses a risk to the safety and soundness of the bank that is similar in many respects to the risk posed by a loan to an affiliate, and may be more volatile and indeterminate than the credit exposure created by a loan.

Determining the appropriate treatment for derivative transactions under section 23A is a complex and important endeavor. In light of the complexities of the subject matter and in light of the May 12, 2001, statutory schedule in the GLB Act, the Board is taking the following two steps to address institution-affiliate derivative transactions under sections 23A and 23B. First, the Board is publishing this interim rule, which (i) requires, under section 23A as amended by the GLB Act, that an institution establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from the institution's derivative transactions with affiliates and (ii) clarifies that institution-affiliate derivative transactions are subject to the market terms requirement of section 23B. The policies and procedures must at a minimum provide for monitoring and controlling the credit exposure arising from the institution's derivative transactions with each affiliate, and all affiliates in the aggregate, and ensuring that the institution's derivative transactions with affiliates comply with section 23B. In addition, the interim rule defines the term ''derivative transaction'' to mean any derivative contract covered by the Board's capital adequacy guidelines (which includes most interest-rate, currency, equity, and commodity derivative contracts) and any similar derivative contract, including credit derivative contracts.

Second, the Board has included provisions in the proposed Regulation W issued concurrently with this interim rule to address further the credit exposure associated with derivative transactions. Regulation W proposes a set of questions on measures in addition to those contained in this interim rule that could be applied to institution-affiliate derivative transactions under section 23A. In connection with this interim rule and proposed Regulation W, the Board solicits public comment on the most appropriate treatment under section 23A of the credit exposure arising from derivative transactions.

As noted above, regardless of how the Board ultimately decides to address credit exposure on derivative transactions between an institution and an affiliate under section 23A, these transactions are subject to the market terms requirement of section 23B. Accordingly, each institution should have in place credit limits on its derivatives exposure to affiliates that are at least as strict as the credit limits the institution imposes on unaffiliated companies that are engaged in similar businesses and are substantially equivalent in size and credit quality. Similarly, each institution should monitor derivatives exposure to affiliates in a manner that is at least as rigorous as it uses to monitor derivatives exposure to comparable unaffiliated companies. In addition, each institution should price, and require collateral in, derivative transactions with affiliates in a way that is at least as favorable to the institution as the way the institution would price, or require collateral in, a derivative transaction with comparable unaffiliated counterparties.

Although the Board continues to explore and analyze the complex issue of how best to address institution-affiliate derivative transactions under section 23A, the Board has not made a determination at this time that the credit exposure arising from such derivatives ought to be made subject to all the requirements of section 23A. The Board continues to collect information regarding the derivatives practices of insured depository institutions and asks for additional data on such practices in order to assist the Board in determining whether the approach set forth in the interim rule would suffice to prevent institutions from incurring material credit exposure to affiliates on derivative transactions. It appears that several of the larger insured depository institutions that participate in the derivatives markets increasingly manage credit risk arising from derivatives exposure to financial institutions by requiring such counterparties to post collateral. The Board understands that these institutions generally require full collateralization of their current credit exposure (*i.e.,* positive net mark-to-market values recalculated daily based on the previous day's exposures) on derivative transactions with financial institutions above a relatively small threshold amount.

The Board requests information regarding (i) how institutions currently measure, monitor, and limit derivatives credit exposure to unaffiliated companies; (ii) whether institutions include an estimate of potential future exposure in their measurement of credit exposure to unaffiliated derivatives counterparties and, if so, how institutions estimate potential future exposure on a derivative transaction; (iii) in what circumstances and to what extent institutions require unaffiliated counterparties to post collateral to secure derivatives credit exposure; (iv) what types of collateral institutions accept to secure derivatives credit exposure (and what haircuts are used for the various collateral types); (v) how often institutions mark to market (and require additional collateral with respect to) their derivative transactions with unaffiliated counterparties; (vi) how institutions price derivative transactions with unaffiliated counterparties; and (vii) how large the uncollateralized derivatives credit exposures are that institutions have to unaffiliated companies.

After a more complete review and analysis of the credit risk mitigation practices of insured depository institutions participating in the derivatives markets and of the public comments received on this interim rule and Regulation W, the Board may decide to subject credit exposure on institution-affiliate derivatives to some or all of the requirements of section 23A.

B. Intraday Extensions of Credit

As noted above, the GLB Act requires the Board to address as covered transactions under section 23A the credit exposure arising from intraday extensions of credit by insured depository institutions to their affiliates. Depository institutions regularly provide transaction accounts to their affiliates in conjunction with providing

[3] In addition to applying to covered transactions as defined in section 28A, the market terms requirement of section 23B applies broadly to, among other things, ''[t]he payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise.'' 12 U.S.C. 371c–1(a)(2)(C). Institution-affiliate derivatives generally involve a contract or agreement to pay money to the affiliate or furnish risk management services to the affiliate.

payment and securities clearing services. As in the case of unaffiliated commercial customers, these accounts are occasionally subject to overdrafts during the day that are repaid in the ordinary course of business. The Board has not to date ruled on whether these or other types of intraday credit extensions are covered transactions under section 23A or are subject to the market terms requirement of section 23B.

Existing business practices indicate that the potential risk reduction benefits afforded by full application of the requirements of section 23A to intraday credit exposures may not justify the costs to banking organizations of implementing these requirements at this time. Intraday overdrafts and other forms of intraday credit extensions are generally not used as a means of funding or otherwise providing financial support for an affiliate. Rather, these credit extensions typically facilitate the settlement of transactions between an affiliate and its customers when there are mismatches between the timing of funds sent and received during the business day. Although some risk exists that such intraday credit extensions could turn into overnight funding of an affiliate, this risk may be sufficiently remote that application of the strict collateral and other requirements of section 23A would not be warranted for the intraday credit exposure. Moreover, mandating that banks collateralize intraday exposures could require banks to measure exposures across multiple accounts, offices, and systems on a global basis and to adjust collateral holdings in real time throughout the day. The Board is concerned that few banks currently have these capabilities and that they would be very costly to implement.

As with institution-affiliate derivative transactions, the Board is taking a two-step approach to addressing intraday credit extensions by an institution to an affiliate under sections 23A and 23B. First, the Board is publishing this interim final rule. The interim rule (i) requires, under section 23A, that institutions establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from the institution's intraday extensions of credit to affiliates and (ii) clarifies that intraday extensions of credit by an insured depository institution to an affiliate are subject to the market terms requirement of section 23B. The policies and procedures must at a minimum provide for monitoring and controlling the institution's intraday credit exposure to each affiliate, and all affiliates in the aggregate, and ensuring that the institution's intraday credit extensions to affiliates comply with section 23B.

Second, the Board has proposed in Regulation W an alternative approach that would subject certain intraday credit extensions to section 23A. The Board specifically invites public comment on whether the Board's final rule on intraday credit extensions under section 23A should reflect the approach taken in this interim rule, the approach set forth in proposed Regulation W, an approach that more fully subjects intraday credits to section 23A, or another approach.

C. Delayed Effective Date

The GLB Act authorizes the Board to delay the effective date of its final rule under section 23A on derivative transactions and intraday credit extensions "for such period as the Board deems necessary or appropriate to permit banks to conform their activities to the requirements of the final rule without undue hardship." [4] Pursuant to this authority, the Board has determined to delay the effective date of these interim final rules until January 1, 2002, to allow institutions an appropriate amount of time to put in place the policies and procedures required by the rules. The delayed effective date also will provide the Board with an opportunity to revise the interim rules to reflect public comments as necessary.

Regulatory Flexibility Act

In accordance with section 3(a) of the Regulatory Flexibility Act (5 U.S.C. 603(a)), the Board must publish an initial regulatory flexibility analysis with this rulemaking. The rules implement provisions of section 121 of the GLB Act that require the Board to adopt final rules under section 23A of the Federal Reserve Act to address as a covered transaction the credit exposure arising out of derivative transactions between insured depository institutions and their affiliates and intraday extensions of credit by institutions to their affiliates.

The interim rules require insured depository institutions to establish and maintain policies and procedures regarding their derivative transactions with affiliates and intraday credit extensions to affiliates. The policies and procedures required by the rules are necessary to ensure that institutions conduct these activities in a safe and sound manner and to enable the Board to execute properly its supervisory function. These requirements apply to all insured depository institutions, regardless of size, engaged in these activities. The Board believes that institutions that engage in these activities, in most cases, already have policies and procedures in place to manage the risks of these activities.

The Board specifically seeks comment on the likely burden that the interim rules will impose on insured depository institutions that engage in derivative transactions with affiliates or extend credit on an intraday basis to affiliates.

Administrative Procedure Act

The provisions of these rules are effective on January 1, 2002, on an interim basis. Pursuant to 5 U.S.C. 553, the Board finds that it is impracticable to issue these rules in proposed form and that there is good cause to issue these rules as interim final rules due to the fact that the GLB Act requires the Board to adopt final rules addressing the credit exposure arising from derivative transactions between institutions and affiliates and intraday extensions of credit from institutions to affiliates by May 12, 2001. The Board is seeking public comment on all aspects of the interim rules and will amend the rules as appropriate after reviewing the comments.

Subject to certain exceptions, 12 U.S.C. 4802(b)(1) provides that new regulations and amendments to regulations prescribed by a Federal banking agency that impose additional reporting, disclosure, or other new requirements on an insured depository institution must take effect on the first day of a calendar quarter that begins on or after the date on which the regulations are published in final form. In accordance with this provision of the Administrative Procedure Act, these interim rules do not become effective until January 1, 2002.

Paperwork Reduction Act

The Board has determined that the interim rules do not involve a collection of information pursuant to the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

Plain Language

Section 722 of the GLB Act requires the Board to use "plain language" in all proposed and final rules published after January 1, 2000. In light of this requirement, the Board has sought to present its interim rules in a simple and straightforward manner. The Board invites comments on whether there are additional steps the Board could take to make the rules easier to understand.

List of Subjects in 12 CFR Part 250

Federal Reserve System.

[4] 12 U.S.C. 371c(f)(3)(B).

For the reasons set out in the preamble, the Board amends 12 CFR part 250 as follows:

PART 250—MISCELLANEOUS INTERPRETATIONS

1. The authority citation for part 250 is revised to read as follows:

Authority: 12 U.S.C. 78, 248(i), 371c(f) and 371c–1(e).

2. Section 250.247 is added to read as follows:

§ 250.247 Application of sections 23A and 23B of the Federal Reserve Act to derivative transactions between insured depository institutions and their affiliates.

(a) Derivative transactions between an insured depository institution and its affiliates are subject to the market terms requirement of section 23B(a)(1) of the Federal Reserve Act (12 U.S.C. 371c–1(a)(1)).

(b) An insured depository institution must establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from its derivative transactions with affiliates in a safe and sound manner. The policies and procedures must at a minimum provide for:

(1) Monitoring and controlling the credit exposure arising from the institution's derivative transactions with each affiliate and all affiliates in the aggregate; and

(2) Ensuring that the institution's derivative transactions with affiliates comply with section 23B.

(c) For purposes of this regulation, derivative transactions include any derivative contract listed in paragraphs A. III. E. 1. a. through d. of appendix A to 12 CFR part 225 and any similar derivative contract, including credit derivative contracts.

3. Section 250.248 is added to read as follows:

§ 250.248 Application of sections 23A and 23B of the Federal Reserve Act to intraday extensions of credit by insured depository institutions to their affiliates.

(a) Intraday extensions of credit by an insured depository institution to its affiliates are subject to the market terms requirement of section 23B(a)(1) of the Federal Reserve Act (12 U.S.C. 371c–1(a)(1)).

(b) An insured depository institution must establish and maintain policies and procedures reasonably designed to manage the credit exposure arising from its intraday extensions of credit to affiliates in a safe and sound manner. The policies and procedures must at a minimum provide for:

(1) Monitoring and controlling the credit exposure arising from the institution's intraday extensions of credit to each affiliate and all affiliates in the aggregate; and

(2) Ensuring that the institution's intraday extensions of credit to affiliates comply with section 23B.

By order of the Board of Governors of the Federal Reserve System, May 3, 2001.

Dated: May 3, 2001.

Jennifer J. Johnson,

Secretary of the Board.

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