

July 16, 2003

Re: Extensions of Credit to Bank Subsidiary

Dear \_\_\_\_\_ :

This letter responds to your request for a determination by the Pennsylvania Department of Banking (the "Department") of whether the lending limit contained in Section 306(a) of the Banking Code of 1965 (the "Banking Code"), 7 P.S. § 306(a), or the limits on loans or extensions of credit to affiliates contained in Sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c and 371c-1, made applicable to Pennsylvania state-chartered banks by Section 311(e.1) of the Banking Code, 7 P.S. § 311(e.1), would apply to a line of credit extended by your client, [redacted] (the "Bank"), a Pennsylvania state-chartered bank, to a limited liability company subsidiary in which the Bank proposes to acquire a 51% ownership interest.

#### Background

You indicate the following factual background, which is essentially quoted directly from your letter.

The Bank proposes to acquire a 51% percent share in a limited liability company (the "Subsidiary") that brokers and originates residential and commercial mortgage loans. Specifically, the Subsidiary will market residential mortgage loans to consumers and process the loan applications. Ultimately, the residential mortgage loans will be originated and funded by the Bank. With regard to commercial mortgage loans, the Bank will process and underwrite such transactions, and such loans will ultimately be originated and funded by the Subsidiary. Pursuant to the terms of the Subsidiary's operating agreement, the Bank will maintain and exercise control over the functions and activities of the Subsidiary both by virtue of the Bank's 51% ownership interest in the Subsidiary and by electing managers of the Subsidiary who have a majority of the voting rights interest among the board of managers of the Subsidiary.

The Bank proposes to make an initial capital contribution to the Subsidiary in the amount of \$10,000. The Bank also proposes to extend to the Subsidiary a line of credit (the "Line of Credit") in an amount of up to \$10,000,000 in order to fund the Subsidiary's origination of

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commercial mortgage loans. The Line of Credit will be on terms provided to similarly-situated customers of the Bank of comparable creditworthiness and size.

You indicate in your letter that the Subsidiary does not constitute any of the entities that are considered “affiliates” by operation of the exceptions to the definition of subsidiary contained in 12 C.F.R. § 223.2(b)(1).

### Legal Analysis

#### *Lending Limit- Section 306 of the Banking Code*

Section 306(a) of the Banking Code provides in pertinent part that:

[a]n institution shall not at any time acquire indebtedness of any one customer (which includes an individual or any legal entity) of the types specified in this section, in an amount which together with all other such indebtedness then held would exceed fifteen percent of the capital accounts of the institution . . . .

7 P.S. § 306(a). The Department has previously opined in a letter dated May 26, 1994 (the “May 26, 1994 Letter”), that the lending limit restriction of Section 306(a) does not apply to loans made by a Pennsylvania state-chartered bank to its wholly-owned mortgage subsidiary.<sup>1</sup> This conclusion was based upon the fact that (1) such subsidiary could have been organized as an internal department of the bank, thereby permitting bank management to invest funds in the mortgage department without concern over legal lending limits; (2) the restrictions regarding interaffiliate lending applicable to Federal Reserve member banks under Sections 23A and 23B

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<sup>1</sup> A “subsidiary” is defined in Section 102 of the Banking Code as “a corporation controlled by an institution which owns at least a majority of its shares,” 7 P.S. § 102(bb.1), and as “a corporation or other entity defined as a subsidiary by section 2 of the Bank Holding Company Act of 1956 (70 Stat. 133, 12 U.S.C. § 1841 et seq.), regardless of whether the corporation or other entity is a subsidiary of a bank holding company,” 7 P.S. § 102(ii). Section 2 of the Bank Holding Company Act defines a subsidiary as “. . . (1) any company 25 per centum or more of whose voting shares (excluding shares owned by the United States or by any company wholly owned by the United States) is directly or indirectly owned or controlled by [a] bank holding company, or is held by it with power to vote; (2) any company the election of a majority of whose directors is controlled in any manner by [a] bank holding company; or (3) any company with respect to the management or policies of which [a] bank holding company has the power, directly or indirectly, to exercise a controlling influence, as determined by the Board [of Governors of the Federal Reserve System], after notice and opportunity for hearing.” 12 U.S.C. § 1841(d). The definition at Section 102(bb.1) was added to the Banking Code by Act 199 of 1970, while the definition at Section 102(ii) was inserted by Act 89 of 2000. The Department believes that the Pennsylvania General Assembly intended that the definition of “subsidiary” at Section 102(ii) replace the definition at Section 102(bb.1). However, due to a legislative oversight, the definition at Section 102(bb.1) was not deleted when Section 102(ii) was added in 2000, thus resulting in the two separate definitions of “subsidiary” in Section 102 of the Banking Code. The Department does not believe that it was the intent of the General Assembly to provide two separate definitions of “subsidiary” in Section 102 of the Banking Code. Based upon the foregoing, and pursuant to the Statutory Construction Act, the definition of “subsidiary” that appears at Section 102(ii), which is the latest enacted definition, is controlling. See 1 Pa.C.S.A. §§ 1934, 1936. Therefore, it is the Department’s position that the definition of “subsidiary” under the Banking Code is the definition that appears at Section 102(ii) of the Banking Code.

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of the Federal Reserve Act do not apply to Federal Reserve member banks making loans to their wholly-owned subsidiaries; and (3) the Office of the Comptroller of the Currency (“OCC”) does not apply its lending limits to national banks lending to their operating subsidiaries.

As a comparative matter, Part 32 of the OCC regulations, relating to the lending limits of national banks, provides in pertinent part that:

[t]his part applies to all loans and extensions of credit made by national banks and their domestic operating subsidiaries. *This part does not apply to loans made by a national bank and its domestic operating subsidiaries to the bank's "affiliates," as that term is defined in 12 U.S.C. § 371c(b)(1), to the bank's operating subsidiaries, or to Edge Act or Agreement Corporation subsidiaries.*

12 C.F.R. § 32.1(c)(1) (emphasis added). A national bank may invest in an operating subsidiary if the national bank “. . . owns more than 50 percent of the voting (or similar type of controlling) interest of the operating subsidiary; or the [national] bank otherwise controls the operating subsidiary and no other party controls more than 50 percent of the voting (or similar type of controlling) interest of the operating subsidiary.” 12 C.F.R. § 5.34(e)(2).

Consistent with the analysis contained in the May 26, 1994 Letter, and in order to maintain competitiveness with national banks pursuant to Section 103(a)(v) of the Banking Code, 7 P.S. § 103(a)(v), it is the Department’s position that the lending limit contained in Section 306(a) of the Banking Code does not apply to loans or extensions of credit made by a Pennsylvania state-chartered bank to a subsidiary in which a Pennsylvania state-chartered bank has a controlling ownership interest. In support of this position, the Department recognizes that the Bank could avail itself of parity with national banks’ ability to lend or extend credit to operating subsidiaries without regard to applicable lending limits, pursuant to Section 201(c)(i) of the Banking Code, 7 P.S. § 201(c)(i).

*Interaffiliate Transactions- Section 311(e.1) of the Banking Code*

Regarding interaffiliate transactions, Section 311(e.1) of the Banking Code provides that:

[a]n institution may engage in a transaction with an affiliate, including the extension of credit to acquire or hold shares of capital securities of an affiliate, if the institution complies with the requirements of 12 U.S.C. § 371c-1. The department shall interpret the requirements of 12 U.S.C. § 371c-1 in a manner consistent with regulations, orders and interpretations as issued by the Board of Governors of the Federal Reserve System.

7 P.S. § 311(e.1).

As a general matter, Sections 23A and 23B of the Federal Reserve Act restrict the amount of loans or extensions of credit to affiliates. Subsidiaries are specifically excluded from the

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definition of “affiliate” under Sections 23A and 23B of the Federal Reserve Act. *See* 12 U.S.C. §§ 371c(b)(2)(A) and 371c-1(d)(1). In addition, Regulation W, which clarifies and interprets Sections 23A and 23B of the Federal Reserve Act, states that the term “affiliate” does not include:

[a]ny company that is a subsidiary of the member bank, unless the company is:

- (i) A depository institution;
- (ii) A financial subsidiary;
- (iii) Directly controlled by:
  - (A) One or more affiliates (other than depository institution affiliates) of the member bank; or
  - (B) A shareholder that controls the member bank or a group of shareholders that together control the member bank;
- (iv) An employee stock option plan, trust, or similar organization that exists for the benefit of the shareholders, partners, members, or employees of the member bank or any of its affiliates; or
- (v) Any other company determined to be an affiliate under paragraph (a)(12) of this section; . . . .

12 C.F.R. § 223.2(b)(1). Based upon the foregoing, the restrictions concerning the amount of loans or extensions of credit made to affiliates contained in Sections 23A and 23B of the Federal Reserve Act do not apply to loans or extensions of credit made by banks to their subsidiaries, provided that such subsidiaries are not entities that are considered affiliates by operation of the exceptions to the definition of subsidiary contained in 12 C.F.R. § 223.2(b)(1). Therefore, for the same reason, the limits on loans or extensions of credit to affiliates contained in Sections 23A and 23B of the Federal Reserve Act, made applicable to Pennsylvania state-chartered banks by Section 311(e.1) of the Banking Code, do not apply to loans or extensions of credit made by Pennsylvania state-chartered banks to their subsidiaries.

### Conclusion

It is the Department’s position that the lending limit contained in Section 306(a) of the Banking Code does not apply to loans or extensions of credit made by a Pennsylvania state-chartered bank to a subsidiary in which a Pennsylvania state-chartered bank has a controlling ownership interest. In addition, the limits on loans or extensions of credit to affiliates contained in Sections 23A and 23B of the Federal Reserve Act, made applicable to Pennsylvania state-chartered banks by Section 311(e.1) of the Banking Code, do not apply to loans or extensions of credit made by a Pennsylvania state-chartered bank to its subsidiary, provided that such subsidiary is not an entity that is considered an affiliate by operation of the exceptions to the definition of subsidiary contained in 12 C.F.R. § 223.2(b)(1).

Based upon the foregoing, the Line of Credit that the Bank intends to extend to the Subsidiary as described in this letter is not subject to the lending limit contained in Section 306(a) of the

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Banking Code or the limits regarding interaffiliate transactions made applicable to the Bank by Section 311(e.1) of the Banking Code.

Please be advised that the Bank must obtain the approval of the Department prior to acquiring the Subsidiary pursuant to Section 203(d) of the Banking Code, 7 P.S. § 203(d), by filing a Bank Subsidiary Notice, which is available on the Department's website at [www.banking.state.pa.us](http://www.banking.state.pa.us).

The statements made herein regarding Sections 23A and 23B of the Federal Reserve Act, and regulations related thereto, are not binding upon the Board of Governors of the Federal Reserve System. For purposes of Section 311(e.1) of the Banking Code, the Department believes that the statements made herein concerning the applicability of Sections 23A and 23B of the Federal Reserve Act, and regulations related thereto, to Pennsylvania state-chartered banks are consistent with regulations, orders and interpretations as issued by the Board of Governors of the Federal Reserve System.

The Department's analysis is based upon the facts as stated in this letter. Any change in the facts could result in an amendment or reversal of the Department's position. This letter has been authorized by the appropriate Department personnel and constitutes a duly authorized statement of the Department's position regarding the issues discussed herein. This letter may not be relied upon or construed as constituting legal advice.

Please do not hesitate to contact me if you have any further questions regarding this matter.

Sincerely,

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Staff Counsel

cc: Ronald P. Wysochansky  
Deputy Secretary of Banking

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