

Fees and Payments Assessed by Parent Holding Companies on Bank Subsidiaries

Board of Governors of the Federal Reserve System March 19, 1979 Policy Statement

As primary supervisory agency for bank holding companies and state member banks, the Federal Reserve is concerned with the whole range of fees and payments assessed by parent holding companies on their commercial bank subsidiaries. Of primary concern are excessive, unjustifiable management or service fees and any other unwarranted payments or practices that, by diverting bank resources to the parent company or a nonbank affiliate, may have an adverse financial impact on the subsidiary (paying) bank. The activities in question come under the broad heading of "diversion-of-bank-income practices".

In general, diversion-of-income practices include, but are not limited to, the following:

1. Management or service fees, or other payments assessed by the parent company or any affiliated entity and paid by the bank, that bear no reasonable relationship to the fair market value, cost, volume or quality of services rendered by the affiliate to the subsidiary bank;
2. Balances maintained by the subsidiary bank primarily in support of parent borrowings without appropriate compensation to the bank;
3. Prepayment of fees to the parent or other nonbank affiliates for services that have not yet been rendered; and
4. Non-reimbursed expenses incurred by the bank that primarily support a nonbank activity.

Such practices are considered inappropriate and, potentially, unsafe and unsound. In determining the specific supervisory response to diversion-of-income practices, materiality, management cooperation and willingness to correct the practices, and overall impact on bank condition must be taken into consideration. If the practices are having a serious impact on the bank's financial condition, or, if the practices, in light of current bank weaknesses, are deemed material and likely to have an adverse impact on the bank's condition, then formal supervisory actions (i.e., written agreements and cease-and-desist orders) should be considered to terminate practices and require restitution or affirmative remedial action. When practices are considered less severe, examiners are to criticize the diversion activities in the Examiner's Comments section of the bank examination and/or holding company inspection report. Such practices should be addressed and eliminated in an appropriate manner as part of the follow-up supervisory process.

To determine the appropriateness of management or service fees, the volume, quality, and market value of the services performed for or provided to the subsidiary bank are to be carefully reviewed. The principal criterion for assessing reasonableness of fees is the relationship of the payments to the fair market value of the services provided. In practice, fair market value may be estimated by analyzing how the marketplace prices similar services in arm's-length transactions in other business contexts and adjusting, if necessary, for any circumstances that are unique to the bank or holding company under examination. If fair market value cannot readily be determined or estimated, the analysis may focus on the cost to the parent of providing a service plus a reasonable profit margin as a proxy for fair market value. While determination of the market value or cost of services rendered may, in actuality, be a complicated and difficult process, the evaluation is necessary to appraise the reasonableness and appropriateness of the fees assessed by the parent company and paid by the bank.

In addition to service fees, the maintenance of bank balances as compensation for holding company borrowings also provides an avenue for the diversion of bank income. In general, this practice is inappropriate unless the bank is being compensated at an appropriate rate of interest. If the bank is not being reimbursed, action should be taken to insure that the bank is compensated for the use of its funds or that the practice is terminated.

The prepayment of service fees to the parent company and bank payment of expenses primarily incurred in conjunction with non-bank holding company activities also are causes for supervisory concern. Prepayment of sums for services that are not to be provided in the immediate future can have an adverse impact on the bank, as can the bank's incurring large expenses on behalf of a holding company affiliate. These practices are addressed by requiring timely and reasonable payments for services and reimbursement to the banks for what are essentially holding company expenses. If bank expenses are substantially incurred in support of a holding company activity, then the bank should be reimbursed for the portion of its cash outlay that benefits the holding company. This is necessary to ensure the bank resources are not diverted to a holding company affiliate with little or no benefit to the bank.

Aside from reasonable and timely fees for services rendered, the most appropriate way, from a supervisory standpoint, for funds to be paid to the parent company is through bank dividends. This applies, in general, to bank payment of funds to service holding company debt, even when the debt is initially incurred to raise equity capital for the subsidiary bank. It is not considered an appropriate banking practice for the subsidiary bank to pay management fees for the purpose of servicing holding company debt. Funds for servicing holding company debt should, as a general rule, be upstreamed in the form of dividends.