

Department of the Treasury

Regulatory Bulletin

**RB 32-12** **RESCINDED**



Handbook: Thrift Activities  
Subject: Various Sections

**Thrift Activities Regulatory Handbook Update**

**Summary:** This bulletin provides updates for the following Thrift Activities Regulatory Handbook sections: 310, Oversight by the Board of Directors; 330, Management Assessment; and 380, Transactions with Affiliates and Insiders. Please replace the existing handbook sections with the enclosed revised sections. We provide a summary of changes for each section below.

**For Further Information Contact:** Your Office of Thrift Supervision (OTS) Regional Office or the Supervision Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: [www.ots.treas.gov](http://www.ots.treas.gov). If you wish to purchase a handbook and a subscription to the updates, please contact the OTS Order Department at (301) 645-6264.

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**SUMMARY OF CHANGES**

OTS is issuing updates to the following Thrift Activities Handbook Sections. Change bars in the margins of handbook section 330 indicate revisions. Totally rewritten handbook sections such as Section 310 and 380 do not have change bars, but we provide a summary of all substantive changes to the Handbook Sections in the listing below. These handbook sections are in plain language to comply with the President's June 1, 1998, memorandum "Plain Language in Government Writing."

**310 Oversight by the Board of Directors**

We revised and reorganized this handbook section to incorporate various regulatory and thrift bulletins, and other regulatory guidance. The term "association in troubled condition" replaces the term "problem association."

**Introduction:** Streamlines.

**Analyzing Board Performance:** New section.

**Reports to the Board:** Transfers from the deleted Board and Committee Reports subsection.

**Qualified Management:** Streamlines text from the deleted Executive Management and Employment Contracts subsections.

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**Board Oversight of Management:** Incorporates and streamlines information previously included in Section 510, Asset/Liability Management, of this regulatory handbook.

**Policies and Procedures:** Condenses guidance from the deleted Sound Policies and Objectives, and Procedures subsections.

**Use of Consultants:** New section.

**Setting Financial Goals: The Risk vs. Return Tradeoff:** Adds information previously included in Section 510, Asset/Liability Management, of this regulatory handbook.

**Types and Sources of Risk Exposure:** Adds guidance from TB 13a.

**Documentation:** Updates.

**Employment Contracts and Executive Compensation:** Incorporates RB 27a.

**Determining Compensation and Directors' Fees:** In addition to RB 27a, incorporates information from the deleted Compensation subsection.

**Operating Results:** Condenses and transfers from the former Capitalization subsection.

**Capital Plan:** New section.

**Prior Approval of Officers and Directors:** Incorporates regulatory changes.

**Prior Approval of Employment Contracts:** Incorporates RB 27a.

**Golden Parachute Provisions:** Incorporates information from FDIC's Golden Parachute and Indemnification Payments regulation, 12 CFR Part 359.

**Regulatory Review of Third-Party Contracts:** Incorporates TB 50.

**Other Requirements:** Adds new section that presents guidance in the areas of conflicts of interest and corporate opportunity.

**Sales of Covered Assets:** Incorporates RB 15.

**Political Contributions and Loans to Political Candidates and Committees:** Streamlines.

**Foreign Corrupt Practices Act of 1977 (FCPA):** New section.

**Regulation O:** Removes the Regulation O requirements on insider extensions of credit from the former Self-Serving Practices subsection to avoid duplication with Section 380.

Adds a cross reference to Handbook Section 380, Transactions with Affiliates and Insiders.

**Reporting of Loans from Correspondent Banks:** Incorporates TB 64-1b.

**Securities Laws:** New section.

**Management Official Interlocks:** New section.

**Indemnification Payments:** New section.

**Program:** Adds, in No. 9, a risk/return profile procedure and a funds management procedure.

**Appendix A, Board of Directors Major Responsibilities Checklist:** Omits. We included this information in the general questionnaire.

**General Questionnaire:** Updates to include the Board of Directors Major Responsibilities Checklist.

## 330 Management Assessment

**Notice of Change of Senior Executive Officers:** Updates guidance to reflect changes to OTS's regulations requiring associations to provide notice before employing senior executive officers, 12 CFR §§ 563.560 and 563.580.

**Safety and Soundness and Compensation Standards:** Rewrites subsection to bring into account OTS's adoption of final rule 12 CFR Part 570 concerning the establishment of safety and soundness standards. Includes references to FFIEC's guidelines.

**Use of Consultants and Outsourcing:** New section.

**References:** Updates regulatory citations due to regulation changes. Adds reference to an FFIEC Interagency Policy Statement.

**Program: Examination Objectives:** Adds new objective regarding outsourcing and use of consultants.

## 380 Transactions with Affiliates and Insiders

This section is new to the Thrift Activities Handbook. We moved this section from the Holding Company Handbook to the Thrift Activities Handbook to ensure that transactions with affiliates and insiders receive the appropriate review regardless of whether the institution is in a holding company structure.

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The guidance reflects changes made by the Federal Reserve to Regulation O. In addition, new material includes a discussion of the § 250.250 exemption on the purchase of loans from an affiliate and a listing of the collateral requirements for loans to affiliates. The material also incorporates the regulatory change made at § 563.41(a)(3) to clarify that a purchase of assets subject to the affiliate's agreement to repurchase the assets is considered a loan or extension of credit unless the transaction meets certain requirements.



—*Scott M. Albinson*  
*Managing Director, Supervision*

**INTRODUCTION**

The board of directors oversees management activities and is ultimately responsible for the affairs of a savings association. Laws and regulations governing board activities require directors to exercise care and loyalty toward the savings association and not to advance their own personal or business interests at the expense of the savings association.

As the financial services industry continues to evolve, the duties of directors are becoming more complex and demanding. Today directors must take an active role in shaping and controlling a savings association's business operations and risks.

**Responsibilities of the Board of Directors**

The directorate has four basic responsibilities:

- To select qualified management and evaluate management's performance.
- To establish business goals, standards, policies, and procedures.
- To review operating results and performance of new and existing activities.
- To ensure compliance with external standards, such as laws and regulations, and the association's own policies and procedures.

In fulfilling these responsibilities, the board of directors should observe the following standards:

- Operate independently from management.
- Attend board meetings regularly.
- Avoid conflicts of interest and self-serving practices.
- Ensure that the association serves the credit needs of its community.

OTS federal charters for mutual and stock associations authorize the number of directors to be not fewer than five nor more than 15, except when the Director of OTS approves a lesser or greater number. A quorum for board meetings is the majority number of directors that an association's bylaws prescribe, even if the association has not yet elected the prescribed number.

For a list of board of directors' statutory and regulatory responsibilities, see the References at the end of this Handbook Section and the Questionnaire.

**Analyzing Board Performance**

Evaluating the effectiveness of a board of directors is an important examination function. The results often provide a useful indicator of an association's future condition and help OTS design a regulatory plan. In carrying out the evaluation, you should perform the following steps:

- Tailor the scope of the examination to the risk profile of the association. A comprehensive assessment of each director and officer usually is not necessary.
- Concentrate on issues rather than on personalities. Analyzing the board's performance is a sensitive process that requires focusing on problem solving, not fault finding.
- Determine the level of director awareness and accountability. Board members should know and fulfill their responsibilities.

To evaluate board effectiveness you must review board minutes and other documents, interview management, and check on the board's response to supervisory directives. In rare instances, you may need to expand the scope of the examination and interview individual directors. You should only need to do this if the information is unavailable from other sources. Meetings with the entire board

provide an additional means of evaluating a board's effectiveness. See Handbook Section 320.

Directors generally welcome regulatory review and specific recommendations for improvements. In unusual cases, however, directors may be uncooperative or attempt to hide instances of incompetence, lack of care, or even fraud or criminal malfeasance. Possible causes for the condition of a troubled association include any of the following reasons:

- Self-dealings or other conflicts of interest.
- Unsafe and unsound practices.
- Management incompetence.
- Lack of director participation.
- Domination of the board by one director or officer.
- Disregard for the regulatory process.

The board is ultimately responsible for prevention or correction of these problems. If the board is unable or unwilling to correct serious problems, you must act immediately to protect the association and ensure its safety and soundness. For more information in this regard, refer to Handbook Section 370, Enforcement Actions.

#### *Board Minutes*

The primary sources of information you need to evaluate a board of directors and its actions are the minutes of its regular and committee meetings. You should review these minutes to determine the status of the following areas:

- Adequacy of Management's Reports to the Board — Management reports submitted to the board should be thorough and accurate and cover all aspects of the association's operations. In particular, reports should document any significant changes to capital, financial performance results, and major business activities. Management should provide such reports to directors before regular board or committee

meetings to allow adequate time for review before the meetings.

- Oversight of Management — Minutes should reflect the board's discussion and approval of any major strategic or operating decisions and the adoption of major operating policies and procedures. Management should obtain board approval before implementing new policies or engaging in new activities.
- Attendance and Participation — The minutes should evidence “regular” attendance by board members. Attendance at 75 percent of all regularly scheduled board meetings is the benchmark for “regular” attendance. Minutes should also identify board members who ask questions or make motions, indicating that they are active in the meetings. Another indicator of active involvement is participation on committees.
- Performance Evaluations — Minutes should reflect the board's election of officers, its review of management performance, and its deliberations regarding salaries and compensation for officers and fees for attorneys, appraisers, directors and others.
- Compliance with Board Directives — Savings associations should have internal systems to monitor operations and ensure that management's actions are appropriate and conform with board-approved policies and directives.

The minutes should support the conclusions the directors reached in the meeting. Board minutes should indicate that the directors studied pertinent documentation and based their decisions upon such documentation. Each director should have the opportunity to review and, if appropriate, modify the minutes before the board ratifies them.

#### *Reports to the Board*

A board's excessive reliance on benchmark financial statistics rather than on comprehensive financial analysis suggests that the directors may not be overseeing the association's affairs appropriately. Undue reliance on only a few indicators

may result in erroneous evaluations of the association's condition. Therefore, you should determine that the reports to the directors include information that is complete, supported, understandable, and accurate.

The quality of report information that management provides to board and committee members is critical in a board's decision-making process. Not only must directors carefully review information that management provides, they must also ensure themselves that the information is complete and contains all pertinent data required to oversee the association.

Each regular board meeting should include a review of financial reports. Directors should not accept questionable report figures at face value, but should question the information and verify it when necessary. The association should promptly follow federal or state examination report recommendations. The audit committee, composed solely of outside directors, if necessary, should provide for annual audits by an independent accounting firm, and should ensure the establishment of and adherence to a system of internal controls.

#### Audit Committee

The board should appoint an audit committee composed of directors who are independent of management and free from any relationship that would interfere with the exercise of independent judgment as a committee member. Members should also be independent of operating personnel who audit procedures, systems or records. Operating personnel may, however, attend meetings to provide necessary information.

The major responsibilities of the audit committee include:

- Handling relations with the independent auditor (such as to select the auditor and to discuss the scope and results of the audit).
- Improving internal auditing functions and controls.

- Establishing policies and procedures that ensure full and accurate disclosure of the association's financial condition.
- Selecting and employing a compliance officer who should be under the direction and control of the audit committee (not management).

All insured institutions with total assets of \$500 million or more must have an independent audit yearly. See Section 350, Independent Audit. Ideally, independent auditors provide an objective look at the performance of the institution. You should carefully review independent audits for the following red flags:

- A qualified or adverse opinion.
- Significant adjustments to net income or capital.
- Internal control deficiencies, especially if recurring or not reported by the internal audit.
- Significant variances in time spent by auditors on the premises or in the audit expense incurred by the institution.
- Significant disagreements between management and the independent auditors.
- Significant variances from findings in the reports of examination.
- Failure of management to submit a plan for the correction of deficiencies.
- Late audit reports (more than 90 days from fiscal year-end).

#### Compliance Officer and Audit

A compliance officer may also be part of a sound checks and balances system. It is the duty of this officer to monitor all association business transactions to ensure their compliance with regulatory provisions and their safety and soundness.

The internal compliance officer, the audit committee, or the outside auditor, should annually prepare a compliance audit report. An audit of this nature

will give the association an opportunity to resolve any internal problems that might otherwise be the subject of an adverse examination report.

### Qualified Management

A board's most important responsibility is to select a capable managing officer (or chief executive officer) for the association. Capable management and personnel are the most important factors contributing to the success of the savings association.

Directors should give the chief executive the latitude he or she needs to run day-to-day operations; therefore, the board must be certain that the person is competent and trustworthy. As a further control, the board should define a managing officer's duties and responsibilities in writing and establish an adequate management succession plan. (See Section 330, Management Assessment.) The board should also establish reasonable compensation packages, including appropriate incentives, for executive officers. In addition, the directorate is responsible for evaluating the performance of top management.

### *Board Oversight of Management*

The board of directors must ensure that a savings association's management has procedures in place to implement board-adopted policies. The board should ensure that management performs the following functions:

- Follows the board's direction and provides periodic reports to the board concerning policy compliance, such as interest rate risk exposure reports and earnings and capital projections and analysis.
- Periodically reviews the board's policies and, when appropriate, suggests changes.
- Implements and manages operations to achieve the board's financial objectives and establishes operational policies for financial functions.
- Supervises investment portfolio management activities. Invests excess liquid funds in securities that complement the association's overall risk/return profile.

- Maintains an awareness of the economic and interest-rate environment, particularly local economic conditions, prepayment trends, volatility, and related regulatory developments.
- Reviews asset quality, including trends in delinquencies, non-accrual loans, real estate owned, and charge-offs and recoveries. Also reviews the adequacy of reserves and quantifies the effect of non-performing assets on the risk/return profile.
- Develops, reviews, and monitors capital plans, business plans, and strategic plans. Integrates this role with the budgeting function. Also generates variance and rate and volume analysis reports.
- Provides adequate support, planning and oversight when the association enters non-traditional banking activities or new business lines. Considers these activities, which may be organizationally distinct from the association's operations, in connection with the association's overall risk/return profile. Sets specific standards concerning risks and assumptions.
- Manages capital market activities, including capital raising, debt issuance, dividend policies, and merger and acquisition analysis. Considers these activities with the management of the association's overall risk/return profile.
- Ensures that product development activity and pricing comport with the association's overall risk/return objectives. Compares the savings association's product pricing to a sample of key competitors.

### Use of Consultants

The board of directors should remind management to take care in contracting with outside parties that propose to provide business plans or financial models at no direct cost to the association. Such vendors usually expect the association to transact business with them on an exclusive basis, and management may feel an obligation to do so. These vendors will have exclusive access to detailed in-

formation about the association that could lead to proposals or transactions that are not in the association's best interest.

The board should ensure that management does not rely on outside consultants to excess, or use overly simplistic assumptions.

Savings associations sometimes hire third parties, such as consulting firms, investment bankers, lawyers, accountants, or other professionals, to provide services not usually required in the normal course of business. Consultants normally provide such services before and during proposed mergers, capital raising efforts, major asset sales, boards of directors internal investigations, and defenses against regulatory determinations. The board of directors must justify and approve contracts that the association enters into with third parties.

### Policies and Procedures

The board establishes policies as guidelines for an association's activities. Procedures represent the methodology for implementing an activity. Operating policies and procedures are necessary to establish management's strategy to communicate the association's goals and to provide a basis for gauging performance.

The directors must provide a clear framework so that the managing officer can operate and administer the association's affairs. These areas include the business strategy as set forth in the business plan, investment and loan policies, capital planning, funds management, and risk management. The Thrift Activities Handbook covers these areas in other Handbook sections. The board of directors must approve all major policies.

Board policies and procedures should meet the following parameters:

- Establish and provide guidance and direction for an association's operations.
- Exist for all major phases of the association's operations.
- Be tailored to the association's operations and risk profile.

- Provide guidance and promote controlled and efficient operating practices.

Management's implementation of board policies and procedures and the association's adherence to operating standards indicate the effectiveness of the board. Positive indications of successful implementation of policies and procedures include:

- Current policies and procedures.
- Established systems to support stated objectives.
- Required evaluations and benchmarks for measuring and monitoring performance.

### *Business Plan*

Directors are responsible for establishing a business plan that documents major financial policies, including funds management, lending, investments, dividends, growth, and interest rate risk management. For more information on the latter, refer to the Interest Rate Risk Management Handbook Section and Thrift Bulletin 13a. While management may develop such policies at the direction of the board, the directors must thoroughly review and give final approval to each contemplated action. Directors must also approve the association's budget and ensure that it is realistic, allows for secure transactions, and reflects adequate capital.

Ideally, the board should have access to information on economic issues because the performance of the economy affects the savings association's performance. Early recognition of changes in the economy provides notice of new opportunities or potential deterioration of asset quality.

### *Setting Financial Goals: The Risk vs. Return Tradeoff*

Savings associations generally express overall financial return objectives in terms of net earnings maximization or net equity value maximization. These financial goals are subject to internal and external risk factors. The greater the risk embedded in individual assets, portfolios, or the overall institution, the greater the variability of returns over time.

The board of directors and management must realize that the savings association can generate higher returns (earnings or equity value) only if the association takes on greater risk; this is the risk/return tradeoff. The choice between these two alternatives relates to the management of all the association's financial functions.

It is important for the board to develop a rational decision-making process for determining a savings association's optimal risk/return profile. An analysis of the effect of numerous risk/return tradeoffs is crucial to successful financial management. See Handbook Section 510.

#### Types and Sources of Risk Exposure

There are several significant types and sources of risk exposure applicable to savings associations. For each type and source, the board of directors must provide direction to management as to the extent of risk the association may undertake.

**Credit Risk** — The risk that the borrower or issuer will not repay principal or interest on loans or investments. This area of risk includes counterparty credit risk, which is the risk that the counterparties will not honor their commitments for items such as over-the-counter option transactions or derivative instruments.

**Interest Rate Risk** — The vulnerability of an association's financial condition to movements in interest rates. Interest rate risk arises from four sources: repricing (mismatched) risk, yield curve risk, basis risk, and options risk. Repricing risk, the primary source of interest rate risk, comes from timing differences in the maturity and repricing of assets, liabilities, and off-balance sheet positions. Yield curve risk arises when unexpected shifts of the yield curve affect a savings association's income or economic value. Basis risk arises from the imperfect correlation in the adjustment of the rates earned and paid on different financial instruments with otherwise similar pricing characteristics. Option risk arises from options, embedded in many financial instruments, that provide the holder with the right, but not the obligation, to buy, sell, or in some manner alter the cash flows of the instrument. See Thrift Bulletin 13a for a more detailed discussion of interest rate risk. TB 13a requires the

board of directors to establish and maintain an association's interest rate limits.

**Liquidity Risk** — The risk that funds may not be available to meet cash outflows when they arise. Liquidity risk occurs when an association is unable to liquidate assets or obtain adequate funding to continue operating. This situation may occur if the association cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions.

**Other Risks** — Includes operational risk, legal risk, reputation risk, fraud and insider abuse risk, and disasters or catastrophe risks.

#### Documentation

An integral part of a savings association's books and records includes documentation of all business transactions. The records should reflect regulatory compliance and adherence to safe and sound procedures. The directors should have full access to such records and use them in approving loans and other investment transactions.

To facilitate examinations each savings association, affiliate, and subordinate organization should establish and maintain accounting and other records that provide an accurate and complete record of all business it transacts. Associations, affiliates, and subordinate organizations must also ensure that the documents, files, and other material or property comprising the records shall always be available for examinations. For supervisory purposes, associations should retain these original business transaction records until the savings association has two regular examinations and the association and OTS resolve any supervisory matters raised in the examinations. Savings associations must also comply with the records retention requirements of safety and soundness, enforcement, compliance, nondiscrimination and consumer affairs laws and regulations.

Due to differing local customs and state laws, associations should obtain recordkeeping (including microfilming, microfiche, and digital imaging) guidance and advice from local sources, such as attorneys, independent auditors, and income tax consultants. OTS encourages associations to de-

velop and follow a formal written recordkeeping policy and records retention schedule.

### Employment Contracts and Executive Compensation

RB 27a provides guidance for review of compensation provisions and clarifies OTS policy on unsafe and unsound practices relating to executive compensation and employment contracts.

#### Definitions

Compensation includes any payment of money or other items of value in consideration of employment. Compensation includes the following items:

- Base salary
- Commissions
- Bonuses
- Pension and profit sharing plans
- Severance payments
- Retirement
- Director or committee fees
- Fringe benefits
- Payment of expense items for a non-business purpose, or that do not meet the IRS requirements for deductibility by the association.

OTS does not ordinarily consider the grant or exercise of stock options as compensation unless they are sufficiently material in amount or conditioned upon factors that result in incentives that cause supervisory concerns.

A senior executive officer includes any individual who holds the title or performs the function of one or more of the following positions (without regard to title, salary, or compensation):

- President
- Chief executive officer

- Chief operating officer
- Chief financial officer
- Chief lending officer
- Chief investment officer.

Senior executive officer also includes any other person identified by OTS in writing as an individual who exercises significant influence over, or participates in, major policymaking decisions, whether or not hired as an employee.

An employment contract is any agreement, intended to be legally enforceable, that materially affects the terms and conditions of a person's employment.

A savings association is in troubled condition if it meets any of the conditions below:

- OTS notifies the association in writing that OTS has assigned the association a composite numerical rating of 4 or 5 under the Uniform Financial Institutions Rating System or an equivalent rating under a comparable OTS rating system.
- The association is subject to a capital directive, a cease and desist order, a consent order, a formal written agreement, or a prompt corrective action directive relating to the safety and soundness or financial viability of the association.
- OTS informs the institution, in writing, of its troubled condition based on information available to OTS. Such information might include current financial statements, reports of examination, or limited scope review of the institution.

#### General Policy

OTS regulation 12 CFR § 563.39, Employment contracts, allows a savings association to enter into employment contracts with its officers and other employees with the specific approval of the board of directors. Savings associations may not enter

into contracts that constitute an unsafe or unsound practice. The regulation defines as unsafe or unsound any practice that could lead to a material financial loss or damage. OTS regulation 12 CFR § 563.161 provides that compensation to officers, directors, and employees must be reasonable and commensurate with their duties and responsibilities.

#### *Determining Compensation and Directors' Fees*

OTS considers all six CAMELS components rated under the Uniform Financial Institutions Rating System in its review of employment contracts and other compensation arrangements.

OTS generally defers to the savings association's board of directors concerning executive compensation arrangements, provided that the following conditions exist:

- The institution is not in troubled condition.
- The compensation arrangements do not present significant safety or soundness concerns that could lead to material financial loss or damage to the association.
- Members of the board complied with their fiduciary duties in approving the compensation arrangement.

OTS requires the board of directors of each savings association to annually review all employment contracts and compensation arrangements for senior executive officers and directors. The board must also document its justification and approval in board minutes. Directors who have a personal interest in the compensation arrangements should not participate in the deliberations or vote on the arrangements. Renewal or extension of employment contracts requires approval by the board of directors.

In determining the compensation of principal officers, the board of directors should consider at least the following factors:

- The qualifications and experience of the officer.

- The compensation paid to other persons that the association or service corporation employ.
- The compensation paid to persons having similar duties and responsibilities in other insured associations or service corporation affiliates.
- The size of the association or service corporation, and the complexity of its operations.
- The financial condition, especially capital position and income level, of the association or service corporation and the individual's contributions to the association or service corporation.
- Any other amounts the officer receives, either directly or indirectly, for other services performed for the association or service corporation such as fees for serving as appraiser, attorney, escrow agent, insurance agent.
- The value of personnel fringe benefits provided to the employee, and perquisites such as an automobile, club membership, and expense account.

Directors should be keenly aware of their fiduciary responsibilities when they establish fees and benefits for themselves. Each director should keep in mind that a primary responsibility is to establish policies that protect the assets of the association. Thus, in setting its own fees, directors should use factors similar to those used in setting officers' compensation.

The board of directors must also determine and document whether the fees of outside appraisers and attorneys are reasonable and commensurate with the services performed. This is particularly important if the outside appraiser or attorney is an affiliated person. The board should determine whether the fees are comparable to those that other appraisers or attorneys performing similar services charge. The board should also consider the comparative advantages of employing a staff appraiser or attorney to perform appraisal or legal services for the association or service corporation.

*Unsafe or Unsound Compensation Practices*

OTS generally does not require changes to pre-existing contracts in healthy associations. Contract provisions, however, that raise significant safety and soundness concerns will be subject to examination comment or formal enforcement action until the association terminates or modifies the contract. OTS may, on safety and soundness grounds, insist that the board replace unacceptable managers and use its best efforts to renegotiate employment contracts that are excessively burdensome on the association.

OTS reviews compensation provisions in savings associations in troubled condition under the following circumstances:

- During examinations.
- In conjunction with applications that contain compensation arrangements.
- When the association submits employment contracts and compensation payments for review.

You should review, comment, or take other appropriate action to correct unsafe or unsound employment contracts.

OTS considers the guidelines below illustrative examples of unsafe or unsound compensation provisions. Other compensation provisions may also be objectionable depending on individual circumstances. OTS based these guidelines on safety and soundness concerns that are especially important for savings associations in troubled condition. You must use judgment in the application of the guidelines, taking into account the condition of the association, the reason for the provision, and the materiality of the provision.

The illustrative examples of unsafe or unsound compensation provisions include the following:

- Compensation arrangements that provide incentives contrary to the safe and sound operation of the association. For example, compensation based primarily on short-term operating results may encourage unreasonable

risk-taking to achieve short-term profits. The board of directors should closely monitor compensation tied to current operating results.

- Compensation arrangements that significantly exceed compensation paid to persons with similar responsibilities and duties in other insured associations of similar size, in similar locations, and under similar circumstances, including financial health and profitability.
- Contracts that contain automatic renewals or extensions without providing for the board of directors explicit review and approval.
- Contracts that provide for an excessive term. Generally, a term exceeding three years is objectionable.
- Total compensation paid out upon the departure of an employee, regardless of the reason, that exceeds three times the employee's average annual compensation. (The association should not make any payment when termination is for cause.) Total compensation must include payments for the remaining contract term, if applicable, as well as any severance payments. Associations should base average annual compensation on the five most recent taxable years.
- Contracts that do not adequately reflect or define the duties and responsibilities of the employee.
- Compensation programs (including deferred compensation, retirement, and insurance) for independent directors that are not commensurate with their duties, or that jeopardize their independence. For example: vesting requirements that require an independent director to forfeit previously accrued amounts if they do not serve for a minimum number of years.
- Contracts that the savings association collateralizes or otherwise guarantees, unless one of the following conditions are present:

- The terms provide that the contract is unenforceable if the association becomes an association in a troubled condition.
- The regional director approves the contract.

*Note:* Contracts that the holding company guarantees are permissible.

- Contracts that provide for employer reimbursement of costs that employees incurred seeking to enforce employment contract terms in the absence of legal judgment or settlement.
- Change in control provisions that provide for immediate vesting, particularly for savings associations in a troubled condition.
- Contracts that require payment upon the voluntary resignation of the employee.

The foregoing does not apply to employment contracts or other compensation arrangements between a holding company and a holding company executive. OTS does not comment on employment contracts between a holding company and a savings association executive unless such contract or arrangement is likely to adversely affect the financial or managerial condition of the association. If applicable, OTS requires separate employment contracts between a savings association executive and the association, and the savings association executive and the holding company.

Savings associations should include the following golden parachute provision in new and renewed employment contracts. “Any payments made to the employee pursuant to this agreement, or otherwise, are subject to and conditioned upon their compliance with 12 USC § 1828(k) and FDIC regulation 12 CFR Part 359, Golden Parachute and Indemnification Payments.”

### Operating Results

The board of directors is responsible for maintaining an adequate level of capital for the association. See Section 120, Capital Adequacy. You should be alert to salary increases and dividend payouts in an association experiencing

unstable or declining levels of capital or earnings. If an association fails to meet any capital standard, you should question the board of directors and management of the association. They should justify any increases in compensation for principal officers and directors or dividend payouts.

OTS bases its regulatory and supervisory scheme on performance-based standards that tie directly to capital compliance. Well-capitalized, well-managed institutions that do not pose significant supervisory concerns receive significantly less intrusive oversight, including a longer examination cycle.

Presented below are some of the more common restrictions placed on undercapitalized associations or those institutions in troubled condition.

#### Capital Plan

OTS requires a capital restoration plan when an association falls below its adequately capitalized level. The association must adhere to an OTS approved capital restoration plan and comply with all prompt corrective action restrictions.

#### Capital Distribution Restrictions

OTS regulation 12 CFR § 563.134, Capital distributions, establishes limits on capital distributions.

#### Prior Approval of Officers and Directors

Section 563.560 requires savings associations in troubled condition to provide 30 days prior notice to OTS if the association wishes to add a director or employ a senior executive officer. OTS has the authority to disapprove the addition or employment of the individual within a 30-day period. OTS may extend the 30-day period for an additional period not to exceed 60 days and must notify the individual in writing of the extension.

#### Prior Approval of Employment Contracts

A savings association in troubled condition must submit all senior executive officer and director employment contracts to the regional director for prior review. The regional director may extend this

requirement to other employees of the association as well. Compensation at associations in troubled condition requires regulatory scrutiny on a case-by-case basis. OTS must balance the association's need to lower operating expenses against the need to provide a higher than normal level of compensation to attract and retain qualified management.

#### Golden Parachute Provisions

FDIC regulation 12 CFR Part 359, Golden Parachute and Indemnification Payments, implements 12 USC § 1821(k). Part 359 prohibits, with certain exceptions, troubled insured institutions from making golden parachute payments.

The FDIC's Part 359 defines a golden parachute payment generally as any payment that meets the following criteria:

- The institution makes the payment to an institution-affiliated party.
- The payment is contingent on this person's resignation.
- The institution makes the payment while it is in troubled condition.

An institution-affiliated party includes any director, officer, employee, or controlling stockholder (other than a depository institution holding company) of, or agent for, an insured depository institution or depository institution holding company. The rule excepts legitimate business expenses such as the following from the golden parachute payment prohibition:

- Qualified retirement plans.
- Non-qualified "bona fide" deferred compensation plans.
- Nondiscriminatory severance pay plans.
- Other types of common benefit plans.
- Certain payments required by state law.
- Death benefits.

The regulation provides for other limited exceptions in cases involving the hiring of a new manager to improve the institution's condition or when the owners sell a troubled institution without FDIC assistance.

#### Regulatory Review of Third-Party Contracts

Savings associations with a composite CAMELS rating of 4 or 5 may enter into third-party contracts for services outside the normal course of business only with the regional director's pre-approval. Third-party contracts at failed associations frequently have been a waste of scarce resources. The regional director may establish a de minimis threshold amount to apply on a case-by-case basis. This requirement for regional director pre-approval does not apply to contracts in the normal course of business, such as annual audits, debt collection, or routine legal services.

Third-party contracts must not contain provisions detrimental to the savings association or contrary to the public interest. They should receive close regulatory scrutiny since the costs may ultimately increase the cost of an association's failure to the deposit insurance fund. You should use the following guidelines when reviewing such contracts for associations with a composite CAMELS rating of 4 or 5:

- Associations must clearly identify the services the consultant will provide and discuss how they relate to the association's approved business or capital plan.
- The association must provide evidence that fees to be paid and terms of payment are within prevailing market norms and are consistent with the interests of the insurance fund.
- Reimbursable expenses, if provided, should include only necessary costs directly related to the service provided. (OTS does not consider costs such as entertainment and unnecessary travel as reasonable.)
- Each contract must contain a provision stating that the association may cancel for unsatisfactory or non-performance.

- In most circumstances, associations should enter into only one contract for each service a consultant will perform. OTS generally considers multiple contracts to different providers for the same service to be a dissipation of assets.
- The regional director will, within ten calendar days of receipt, notify an applicant association in writing whether it may enter into a proposed third-party contract.

### Other Requirements

Directors should be ever-mindful of the savings association's obligation to serve the community. Directors represent the association and their behavior can enhance or detract from the association's image and ultimately its fiscal well-being. A director's business and personal affiliations should be compatible with those of the association.

You should be alert to self-serving practices that include:

- Gratuities to directors to obtain their approval of financing arrangements.
- The use of particular services.
- The use of association funds by insiders to obtain loans or transact other business.
- Transactions involving a conflict of interest.

### *Conflicts of Interest*

Directors must particularly avoid conflicts of interest of any sort, or even the appearance of a conflict of interest. Also, because a director's personal characteristics may reflect on the association's trustworthiness, a director should be a responsible and trusted member of a community. OTS's regulation on conflicts of interest, 12 CFR § 563.200, prohibits persons who owe a fiduciary duty to a savings association from advancing their own personal or business interests at the expense of the association. This regulation also prohibits persons who owe a fiduciary duty to the savings association from advancing the personal or business interests of others with whom they have a

personal or business relationship at the expense of the association.

The rule would apply in the following situations:

- A person who owes a fiduciary duty to an institution receives money or other benefits (such as a loan, forgiveness of debt, goods or services) from a third party. In return, the third party receives a benefit from the association (such as granting a loan to or buying property from the third party).
- Similarly, payments by the third party to a spouse, child, parent, sibling, or business partner of a person identified in the rule would generally provide a benefit to the person because of the personal or business relationship and would likewise be covered by the rule.
- In addition, a person who owes a fiduciary duty to an institution may not facilitate a transaction between the savings association and companies in which that person owns shares, is on the board of directors, or is an officer, at the expense of the institution.

Generally, OTS will not deem a person to be advancing his, her, or its interests at the expense of the institution if the transaction complies with sections 23A and 23B of the Federal Reserve Act and Federal Reserve Board Regulation O. In addition, the regulation provides that if persons who owe a fiduciary duty to a savings association have an interest in a matter or transaction before the board they must take the following steps:

- Make full disclosure to the board.
- Refrain from participating in the board's discussion of the matter.
- Recuse themselves from voting on the matter if they are a board member.

### Sale of Covered Assets

As a result of FSLIC-assisted transactions, some associations have portfolios of covered assets. Covered assets are assets where the association

receives yield maintenance payments and/or loss coverage upon disposition of the asset. The sale of covered assets to affiliated persons (defined in OTS regulation 12 CFR § 561.5) carries risk to the association and a potential cost to the FDIC. The sale of covered assets to such insiders raises the possibility of negative public perception of such transactions. Although the FDIC reviews the financial terms of all transactions involving covered assets, insider sales may appear as sweetheart deals, even if economically sound. Savings associations should not sell covered assets, as defined by FSLIC Assistance Agreements, to affiliated persons.

#### *Corporate Opportunity*

OTS's corporate opportunity regulation prohibits directors, officers, and persons that have the power to direct the management or policies of a savings association, or otherwise owe a fiduciary duty to an association, from taking advantage of corporate opportunities that belong to the association. OTS follows common law standards governing usurpation of corporate opportunity. Examples of the types of issues the board should consider under this standard:

- The institution's financial condition and management resources.
- The level of risk presented by the business.
- Potential profit from the business weighed against any profits that might arise from transfer of the business.

The rule does not apply when an institution receives fair market value consideration for the transfer of a line of business. In addition, the rule does not generally apply if a disinterested and independent majority of the savings association's directorate, after receiving a full and fair presentation of the matter, rejects the opportunity as a matter of sound business judgment. A disinterested director has no interest in the matter or transaction before the board of directors. An independent director must not be a salaried officer or employee of the savings association, any subsidiary or holding company affiliate; and must not be dominated or controlled by an interested officer or director.

#### *Political Contributions and Loans to Political Candidates and Committees*

The board of directors is responsible for authorizing any political activity by a savings association and must ensure that borrowers properly report political loans.

The Federal Election Commission (FEC) administers, interprets, and enforces the Federal Election Campaign Act of 1971 (the Act) as amended (2 USC § 431). The FEC's implementing regulations that govern political contributions and bank and savings association loans are at 11 CFR Part 100.

The Act and the FEC's regulations apply to the political activities of the following entities:

- Federally chartered corporations in connection with any election, whether federal, state, or local.
- Non-federally chartered corporations in connection with a federal election.

Thus, a state-chartered subsidiary of a federal savings association is usually not subject to the prohibitions governing its federally chartered parent, absent any circumvention of the Act or implementing regulations.

The FEC's rules and regulations prohibit savings associations from making political contributions and paying political expenditures. For federal associations these prohibitions apply to any election, but for state associations the prohibitions apply to federal elections. Directors should consult legal counsel regarding any questionable activities related to political contributions and loans or payment of expenditures to any political candidates or committees.

Besides the Act's requirements and FEC regulations, savings associations may also be subject to state and local political activity laws.

You should report apparent violations and, when appropriate, forward them to your supervisor. OTS may forward the referral to the FEC for enforcement action. You should consider filing a

Suspicious Activity Report when a violation is of a serious, knowing, and willful nature.

Associations may request an FEC advisory opinion from the:

Federal Election Commission  
Office of the General Counsel  
999 E Street, N.W.  
Washington, D.C. 20463

#### *Foreign Corrupt Practices Act of 1977*

Congress designed the Foreign Corrupt Practices Act (FCPA) (15 USC § 78dd — 1&2) to prevent the use of corporate assets for corrupt purposes. The FCPA makes it a crime for a U.S. company (or individuals acting on behalf of a company) to bribe foreign officials or foreign political candidates or parties to acquire or retain business. There is an exception for generally accepted “grease” payments to facilitate processing. The FCPA applies to issuers of registered securities and domestic concerns, their officers, directors, agents, and stockholders. Under the FCPA, the company may be criminally liable if it indirectly engages in prohibited acts through any other person or entity, including a foreign subsidiary.

The FCPA also requires the establishment of internal controls to ensure that organizations execute transactions according to management's authorization and properly record the transactions so as not to disguise corrupt payments. Anyone acting on behalf of a savings association, in any transaction with a foreign official, should have benefit of legal counsel to ensure compliance with the far-reaching provisions of the FCPA.

#### *Regulation O*

Savings association directors bear a major responsibility in dealing with loans to members of the directorate and other insiders. They must make decisions that preclude the possibility of partiality or favored treatment. Losses that develop from unwarranted loans to an association's insiders or to their related interests weaken the association's gen-

eral credit standards. See Handbook Section 380, Transactions with Affiliates and Insiders.

#### *Reporting of Loans from Correspondent Banks*

Under 12 CFR Part 215 Subpart B requirements, executive officers and principal shareholders and their related interests must submit an annual report to their board of directors regarding their indebtedness to correspondent banks. OTS incorporates this provision in 12 CFR § 563.43.

#### *Securities Laws*

Directors of stock associations must take care not to violate federal securities laws in their own securities trading activity. These laws prohibit anyone, insider or not, from purchasing or selling securities with the use of material corporate information that is not available to the general public. Examples of such material inside information include:

- Significant corporate actions.
- Reduced or increased earnings.
- Changes in loan loss reserves.
- Mergers, acquisitions, or proposed tender offers.
- Actual or potential enforcement or supervisory actions.
- A change in supervisory status (such as a prompt corrective action category or a CAMELS rating).

Federal securities laws also prohibit insiders from passing inside information to other persons, even if the insider does not actually trade securities based on such information.

Related to insider trading prohibitions are short swing profit recovery provisions of § 16 of the Securities Exchange Act of 1934 (15 USC § 78c). A “short swing” transaction generally includes purchases and sales, or sales and purchases, of equity securities within a period of six months. Section 16(b) provides that an issuer, or shareholder acting on behalf of an issuer, may recover from an insider

any profits realized on certain short swing transactions.

Corporate insiders have a fiduciary responsibility of trust and confidence to refrain from trading based on material non-public information concerning their corporation. The misuse of material non-public corporate information is a fundamental breach of fiduciary duty and an unsafe and unsound practice.

### Other Areas of Review

#### *Management Official Interlocks*

OTS regulations also address management official interlocks and depository interlocks. See OTS regulation 12 CFR Part 563f. A management official of a depository institution or depository holding company may not generally serve as a management official of another depository institution or depository holding company if the two organizations are not affiliated and are very large or located in the same local area.

#### *Indemnification Payments*

A federal savings association may indemnify its directors, officers, and employees according to OTS regulation 12 CFR § 545.121. Such indemnification however, is subject to and qualified by 12 USC § 1821(k). This regulation limits the ability of insured institutions to pay the liabilities or legal expenses of a director or employee who is subject to an enforcement proceeding.

Part 359 in the Code of Federal Regulations limits indemnification payments. The rule generally prohibits indemnification payments made to or for an institution-affiliated party in connection with a civil money penalty or judgment resulting from a federal administrative or civil enforcement action instituted by any federal banking agency. The rule also prohibits liability or legal expenses with regard to administrative proceedings or civil actions instituted by any federal banking agency that results in a final order or settlement pursuant to which an institution-affiliated party is:

- Assessed a civil money penalty.
- Removed from office.

- Prohibited from service.
- Subject to various other penalties.

The rule permits institutions to buy commercial insurance to cover expenses other than judgments and penalties. The rule also permits the institution to pay up front for an employee's legal or other professional expenses if the institution's board makes certain findings, and the employee agrees to reimburse the institution if the alleged violation is upheld.

#### *Insurance*

##### Fidelity Bond Coverage

Savings associations must maintain adequate fidelity bond and directors' and officers' insurance coverage. Directors should periodically review the adequacy of this coverage and review carefully the riders thereto that might impair its utility. The terms of these policies are negotiable. See Section 330, Management Assessment.

##### Life Insurance

It is common practice for savings associations to buy life insurance policies for the benefit of employees. Institutions may also obtain key-person protection for the association. If the beneficiary of the policy is the savings association, refer to Handbook Section 250, Other Assets/Liabilities, for applicable policy and review procedures. If the beneficiary of the policy is the employee, OTS considers the cost of the coverage to be compensation. The board should annually review and approve the policy for reasonableness.

### REFERENCES

#### **United States Code (2 USC)**

The Federal Election Campaign Act of 1971

#### **United States Code (12 USC)**

§ 375b (22(h))	Extensions of Credit to Executive Officers, Directors, and Principal Shareholders of Member Banks		<i>Chapter V: Office of Thrift Supervision Rules and Regulations</i>
§ 1817(a)(3)	Reports of Condition	§ 544.5	Federal Mutual Savings Association Bylaws
<b>United States Code (15 USC)</b>		§ 545.121	Indemnification of Directors, Officers and Employees
§ 78m	Periodical and Other Reports	§ 552.6-1	Board of Directors
§ 78dd-1&2	Prohibited Foreign Trade Practices/Foreign Corrupt Practices Act of 1977	§ 560.130	Prohibition on Loan Procurement Fees
		§ 561.18	Director
§ 1828(k)	Authority to Regulate or Prohibit Certain Forms or Benefit to Institution-Affiliate	§ 563.33	Directors, Officers and Employees
		§ 563.39	Employment Contracts
		§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
<b>Code of Federal Regulations (12 CFR)</b>		§ 563.42	Additional Standards Applicable to Transactions with Affiliates and Subsidiaries
<i>Chapter II: Federal Reserve Board Rules and Regulations</i>		§ 563.43	Loans by Savings Associations to their Executive Officers, Directors and Principal Shareholders
Part 215	Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (Regulation O)	§ 563.161	Management and Financial Policies
		§ 563.200	Conflicts of Interest
		§ 563.201	Corporate Opportunity in Savings Associations
<i>Chapter III: Federal Deposit Insurance Corporation Rules and Regulations</i>		§ 563.555	Notice of Change in Control of Director or Senior Executive Officer
Part 359	Golden Parachute and Indemnification Payments	Part 563f	Management Official Interlocks
			<b>Office of Thrift Supervision Bulletins</b>
		RB 3b	Policy Statement on Growth for Savings Associations
		RB 27a	Executive Compensation
		TB 13a	Management of Interest Rate Risk, Investment Securities, and Derivatives Activities
		TB 23a	Sales of Securities
		TB 64-1d	Reporting of Loans from Correspondent Banks

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# Oversight by the Board of Directors Program

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## Examination Objectives

To assess whether the composition of the board of directors provides for sufficient breadth and depth of expertise to ensure adequate oversight of the association's affairs.

To determine whether the board of directors understands fully its duties and responsibilities and is discharging its responsibilities appropriately.

To determine whether the board of directors has adopted adequate policies, procedures, and operating strategies (including internal controls and audit and loan review procedures) to conduct the association's operations prudently.

To determine the existence of any conflicts of interest or improprieties involving directors.

To determine the extent of compliance with statutory and regulatory requirements applicable to directors of financial associations.

## Examination Procedures

Wkp.Ref.

### Level I

1. Review the association's business plan, budgets, and policy statements. Determine if the board of directors establishes objectives and policies for the association in general and for specific relevant areas of operation. Determine whether objectives and policies are compatible with applicable laws, regulations, the charter or articles of incorporation, bylaws, and conditions for insurance of accounts. Evaluate the adequacy of stated policies in providing direction to management.

2. Review board of director's minutes of regular, special, and committee meetings; consider director attendance at the meetings. Determine whether minutes are complete, the extent of significant changes in direction, activities, or policy for the association, and whether specific changes require modification of the scope of the examination. Update the continuing examination file (CEF), if applicable, with new or revised policies (or reference the policies if not retained). You should inform other examiners of noteworthy information found during the review.

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## Oversight by the Board of Directors Program

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**Wkp.Ref.**

3. Review reports that management prepares for the board. Determine if the information is adequate, accurate, and sufficient to support the board of director's decision making. (Examiners reviewing related areas can perform this procedure.) Provide copies of useful board reports and other information to the other examiners.

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4. Review and evaluate the composition of the board of directors. Ensure that the association meets the requirements in 12 CFR § 563.33. Obtain answers to the following questions and disseminate information regarding directors' interests to the examination team:

- Is there always a quorum, that is, a majority of the directors that the association's bylaws prescribe, at board meetings?
  - Do the directors, as a group, have sufficient expertise and experience?
  - Are three or more of the association's directors members of the same family? Do related directors tend to control board actions?
  - Do two or more directors also work as attorneys with the same law firm?
- 

5. Could the directors' affiliations have any adverse effects on the association's operations and, if so, would a larger board offset the possible adverse effects?

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6. Is there a concentration of board members and, therefore, a concentration of interests in certain businesses (such as real estate or construction)?

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7. Determine whether there were any occurrences of self-dealing or conflicts of interest involving the board of directors.

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8. Complete the General Questionnaire, Oversight by the Board of Directors.

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## Oversight by the Board of Directors Program

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9. Determine whether the board of directors:

- Delegates sufficient authority to management personnel to promote effective and efficient performance, and whether it retains sufficient control to discharge its responsibilities to stockholders, members, customers, OTS, and other regulatory authorities.
- Is actively involved in directing the association's operations, and adequately monitors its performance.
- Provides direction to management as to the development of an optimal risk/return profile.
- Is aware of all the association's funds management procedures, including management's financial modeling processes.
- Provides sound funds management direction to management.
- Reviews and takes appropriate corrective actions to address adverse findings disclosed in audit reports, reports of examinations, and internally generated reports, including internal asset review reports.
- Reviews the level and reasonableness of officers' salaries and affirms that they are commensurate with their experience and duties.
- Provides adequate oversight of the personnel department and its policies.
- Reports annually to the shareholders in the required format, if applicable.

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10. Review employment contracts. Be especially alert for contracts with long terms or overly generous provisions. Determine whether the association employs or retains persons closely related to officers and directors. Determine whether such relationships or inappropriate contracts have affected, or could adversely affect, the system of internal control, employee morale, or association performance. Ensure employee contracts meet the requirements of 12 CFR § 563.39.

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## Oversight by the Board of Directors Program

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**Wkp.Ref.**

11. Interview the managing officer and other key officers, including the chief financial officer and the chief lending officer. Determine whether they keep directors informed of the association's financial position and the potential effect of current economic conditions on the association. Also determine the extent of the directors participation and involvement in resolving current operating problems and establishing long-range objectives and policies.

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12. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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### Level II

13. Obtain answers to the following questions relating to the board of directors:

- Does the board of directors review reports from the executive committee, audit committee, loan committee, other committees of the board, compliance personnel, and outside experts at board meetings?
- Do directors and committee members have the opportunity to review and modify minutes of their meetings before approval?
- Are directors aware of significant regulatory changes enacted during the examination period?
- Has the board appointed a compliance officer?
- Did management consider the results of prior years' compliance reviews and examination reports when they designed procedures for the current compliance review?
- Did the audit committee or the board review the results of the most recent compliance audit?
- Are adequate systems of internal control present to detect noncompliance with regulations?
- Are written responses and plans for corrective action required from management concerning deficiencies noted during the compliance audit?

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## Oversight by the Board of Directors Program

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14. Did each regular director's meeting during the examination period include a review of financial reports of the association and its affiliates? Also, consider the following:
- Do the minutes reflect directors questions concerning financial reports along with the appropriate follow-up and resolutions?
  - Did the board review recommendations concerning fiscal operations in examination reports and the board of director's letter from independent accountants?
  - Did the board approve and prepare written responses to recommendations contained in examination reports and the board of director's letter from the independent accountants?
  - Does the board regularly assess or monitor management's compliance with board approved major financial policies?
  - Do the minutes reflect that the directors thoroughly reviewed and approved the association's budget?
  - Does management include comparisons of budgets with actual results in financial reports reviewed at each board meeting?

15. Did the board establish and do they annually review minimum underwriting standards and guidelines, including a large loan policy? Check the following items:
- Does management establish, and does the board review and approve formal lending limits?
  - In conjunction with the budgeting process and formulation of the business plan, has the board reviewed and approved the types and volume of lending planned by management?
  - Do the association's lending policies require that higher-risk credit extensions and unusual loans (as specifically defined in the policies) be presented to the board for final approval?

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## Oversight by the Board of Directors Program

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16. Do the minutes reflect if the board considered any unusual loans or those exceeding ordinary risk? Do the minutes also reflect the board's approval or disapproval?

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17. Do the minutes reflect that the board, in reviewing higher-risk loans, explored efforts to minimize risk and limit the amount invested?

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18. Has the board implemented an effective internal asset review function?

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19. Review the following items:

- Does the board define, in writing, the managing officer's duties and responsibilities?
- Do the directors generally establish and approve compensation levels and pension plans?

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20. Do directors approve promotions and bonuses and document such approvals in the minutes?

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21. For bonus plans tied to the association's net income, has the board established controls to prevent management from reporting short-term gains at the expense of long-term profitability?

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22. Review directors' compensation for reasonableness. Consider peer group information and the time directors devote to the association's affairs.

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## Oversight by the Board of Directors Program

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**Wkp.Ref.**

23. Determine if operating committees are active between board meetings, and if the committees subsequently report their actions to the board for ratification.

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24. Review the association's bylaws, charter or articles of incorporation, and conditions for insurance of accounts. (Include copies in the CEF or permanent institution file.) Determine if written policies and procedures specify the duties and responsibilities of management personnel and the board of directors.

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25. Review and consider the CAMELS rating in each area in determining your overall conclusions regarding the oversight by the board of directors.

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26. Determine if there is a need to review any association transactions for evidence of self-dealing or conflicts of interest.

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27. Ensure that your review meets the *Examination Objectives* of this Handbook Section. State your findings, conclusions, and recommendations for any necessary corrective measures on the appropriate work papers and report pages.

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## Oversight by the Board of Directors Questionnaire

	Yes	No		Yes	No
<b>General Questionnaire</b>					
<i>Board of Directors - General Requirements</i>					
1. Is the composition of the board within the guidelines of § 563.33(a)? .....			<b>Reporting of Loans from Correspondent Banks - 12 CFR Part 215, § 563.43, TB 64-1c</b>  7. Does the board of directors review the reports of indebtedness to correspondent banks that executive officers and principal shareholders and their related interests must annually submit to the board? .....		
2. Have all directors regularly attended directors' meetings during the year? .....					
3. Does the board of directors regularly review reports from the executive committee, audit committee, loan committee, other committees of the board, compliance personnel, and outside experts at board meetings? .....			<b>Safety and Soundness Standards - 12 CFR Part 570</b>  8. Does the board of directors and senior managers ensure that the system of internal control operates effectively? .....		
4. Has each director had the opportunity to review and modify all minutes of board and committee meetings during the period prior to approval? .....			9. Does the association have an internal audit function that is appropriate to its size and the nature and scope of its activities? .....		
5. Are the minutes complete? .....			<b>Annual Independent Audits and Reporting Requirements - 12 CFR Part 363</b>  10. This section only applies to associations where total assets at the beginning of the fiscal year are \$500 million or more: <ul style="list-style-type: none"> <li>• Has the board of directors established an independent audit committee? .....</li> <li>• Does the committee review with management and the independent public accountant the basis for the reports that 12 CFR Part 363 requires?</li> </ul>		
<i>Conflicts of Interest - 12 CFR § 563.200</i>					
6. Does the board of directors review each director's business and personal interests to ensure that the director does not advance his interests (or interests of others that the director has a personal or business relationship with) at the expense of the savings association? .....			<b>Interest Rate Risk Management Procedures - 12 CFR § 563.176</b>  11. Does the board of directors (or a designated committee of the board) review the savings association's interest rate risk exposure? ....  12. Has the board of directors formally adopted a policy for the management of interest rate risk? .....		
<ul style="list-style-type: none"> <li>• Do board members furnish written conflict-of-interest representations annually? .....</li> </ul>					
<ul style="list-style-type: none"> <li>• Has any director engaged in any transaction with the association or its affiliates where the director received preferential treatment? (Apply particular emphasis to loan terms and instruments.) .....</li> </ul>					
<ul style="list-style-type: none"> <li>• Has any director engaged in any transaction with the association or its affiliates that give the appearance of a conflict of interest? .....</li> </ul>					

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## Oversight by the Board of Directors Questionnaire

	Yes	No		Yes	No
13. Does the board of directors periodically receive reports from management regarding implementation of the interest rate risk policy? .....			<i>Real Estate Lending Standards - 12 CFR § 560.101</i>		
14. Does the board of directors review the results of operations at least quarterly and make adjustments as necessary, including adjustments to the authorized acceptable level of interest rate risk? .....			21. Does the board of directors, at least annually, review and approve lending policies for extensions of credit secured by real estate? .....		
15. Does the board of directors review the results of operations at least quarterly and make adjustments as necessary, including adjustments to the authorized acceptable level of interest rate risk? .....			22. Do the lending policies reflect risk levels that are acceptable to the board and provide clear and measurable underwriting standards? .....		
<i>Financial Derivatives - 12 CFR § 563.172</i>			<ul style="list-style-type: none"> <li>• Do the institution's lending policies require that higher-risk credit extensions and unusual loans (as specifically defined in the policies) be presented to the board for final approval? .....</li> </ul>		
16. Has the board of directors established written policies and procedures governing authorized financial derivatives? .....			<ul style="list-style-type: none"> <li>• Were unusual loans and those exceeding ordinary risk presented to the board during the period, and did the board record their approval or disapproval in the minutes? .....</li> </ul>		
<i>Supervisory Policy Statement on Investment Securities and End-User Derivatives Activity</i>			<ul style="list-style-type: none"> <li>• In reviewing higher-risk loans, did the board explore efforts to minimize risk and limit the amount invested, and did the directors document their review in the minutes? .....</li> </ul>		
17. Has the board of directors approved major policies for conducting investment activities, including the establishment of risk limits? ....			<ul style="list-style-type: none"> <li>• Does the board review the status of all high-risk loans on a regular basis? .....</li> </ul>		
18. Does the board of review portfolio activity and risk levels, and require management to demonstrate compliance with approved risk limits? .....			<i>Appraisal Policies and Practices of Savings Associations and Subordinate Organizations - 12 CFR § 564.8, TB 55a</i>		
<i>Interbank Liabilities - 12 CFR § 206.3</i>			23. Has the board of directors developed, implemented, and maintained appraisal policies to ensure that appraisals reflect professional competence and reliable market value of the collateral? .....		
19. Does the board of directors annually review and approve the association's interbank liability policies and procedures? .....			24. Has the board of directors developed and formally approved written appraisal policies? .....		
<i>Payment Systems Risk - 12 CFR § 210.25</i>					
20. Does the board of directors control the risks of participation in the systems by establishing caps and reviewing policy compliance? .					

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## Oversight by the Board of Directors Questionnaire

	Yes	No		Yes	No
25. Does the board of director's annually review and approve appraisers for compliance with association policies, procedures and reasonableness of estimates? .....			32. Has the board of directors developed and adopted appropriate policies, practices or procedures covering management's responsibilities and controls for all areas of client/server computing activities? .....		
26. Has the board of directors designated one or more persons as the association's environmental risk analyst and assisted in the development of the association's environmental risk policy? .....			<i>Corporate Business Resumption and Information Systems Contingency Planning - CEO Memo Number 72</i>		
<i>Classification of Assets - 12 CFR § 560.160</i>			33. Has the board of directors and senior management established policies and procedures to ensure that comprehensive corporate business resumption, contingency planning, and testing takes place? .....		
27. Does the board of directors ensure that management evaluates and classifies the association's assets on a regular basis in a manner consistent with or reconcilable to OTS's asset classification system? .....			34. Does the board of directors annually review the adequacy of the association's business recovery and contingency plans and results of the tests, and document such review and approval in the board minutes? .....		
<i>Written Security Program - 12 CFR Part 528</i>			<i>Executive Compensation and Employment Contract Oversight - 12 CFR § 563.39, RB 27a</i>		
28. Has the board of directors developed and implemented a written security program for the association's main and branch offices? ..			35. Does the board of directors annually review and approve all employment contracts and compensation arrangements for senior officers and directors? .....		
<i>Report of Condition - 12 USC § 1817(a)(3), TFR Instructions</i>			36. Has the board of directors defined the duties and responsibilities of the institution's managing officer in writing? .....		
29. Do two or more members of the board of directors attest to the report? .....			37. For those bonus plans tied to the performance of the institution has the board established controls to prevent management from reporting short-term gains at the expense of long-term profitability? .....		
<i>Report of Examination - ROE Instructions</i>			38. If the institution uses employment contracts, do they meet the requirements of § 563.39?		
30. Do the directors review the report of examination and sign the Director's signature page for review during the next examination? .....			<i>Bond Coverage for Directors, Officers, Employees, and Agents - 12 CFR § 563.190</i>		
<i>Guidelines for Developing Adequate Control Practices and Responsibilities for End-User Computing Operations - TB 29</i>					
31. Has the board of directors established appropriate policies that identify management responsibilities and control practices for all areas of information processing activities? ..					
<i>Client/Server Computer Systems - CEO Memo Number 59</i>					

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 Reviewed By: \_\_\_\_\_  
 Docket #: \_\_\_\_\_



**INTRODUCTION**

In this Section, management refers to executive officers, such as president, vice president, secretary, treasurer, or controller. It also refers to any persons, including division managers, who have the ability, with or without explicit authority, to implement and interpret the association's policies and procedures.

A major examination objective is to evaluate the quality and effectiveness of management. The success or failure of almost every facet of operations relates directly to management. Management develops procedures and strategies and makes decisions within the policies and guidelines that the board of directors establishes.

In evaluating management performance, you should consider the knowledge, skills, and abilities of the individuals, the results of their decisions, and the association's regulatory compliance and financial performance. There are a number of practices and procedures that management uses to control an association's activities that you must evaluate. These include, but are not limited to, planning, policy making, personnel administration, maintenance of internal controls, loan review, auditing, and maintenance of management information systems. You must consider the following management practices and procedures in your evaluation:

- A demonstrated willingness and technical ability to serve the legitimate banking needs of the community.
- Compliance with laws and regulations, including the adequacy of systems established to ensure compliance.
- Avoidance of conflicts of interest.
- Responsiveness to recommendations from auditors and supervisory authorities.

**Effectiveness of Management**

Assessing management performance involves more than noting whether an association is profitable. Effective management requires the cooperation and active involvement of both management and the board of directors. The board should provide the guidelines, and management should make operating decisions consistent with the guidelines. You must judge management performance on the basis of how well management uses available resources to accomplish the association's objectives.

Evaluations of management provide indicators of future operations; in some instances they may reveal a need for preventive supervision. For associations experiencing problems, evaluations are necessary to determine the capabilities of management so that you may initiate appropriate supervisory action.

OTS has determined that inefficient, incompetent, or dishonest management are the principal causes of the problems of most troubled associations. Although there are many other reasons (high expenses, poor lending practices, high delinquencies, and so on), most of the causes relate to management deficiencies.

In reviewing executive officers' performance, you need to determine that the following conditions exist:

- There is soundness and consistency of objectives, policies, and procedures in the asset, liability, and operational areas.
- Personnel throughout the association adhere to policies.
- The association's management systems facilitate efficient operation and communications and monitor activities.

- The association's planning processes facilitate achievement of goals and objectives.
- Senior management delegates appropriate authorities to middle management and staff personnel.
- Management's experience and depth ensures sound decisions and assures continuity of operations.
- Management is capable of handling situations the association may reasonably encounter in the future.

#### *Notice of Change of Senior Executive Officers*

OTS regulations 12 CFR § 563.550 through § 563.590 require capital deficient or troubled savings associations to notify OTS 30 days before taking either of the following actions:

- Employing a senior executive officer.
- Changing the responsibilities of any senior executive officer so that the person would assume a different senior executive position.

The same regulatory notice requirement also applies to savings and loan holding companies in a troubled condition.

Capital deficient associations meet one of the following conditions:

- Do not comply with all minimum capital requirements.
- OTS notifies the association, in connection with their capital restoration plan, that it must file a notice.

OTS will disapprove a notice if, based on the competence, experience, character, or integrity of the proposed senior executive officer, that it would not be in the best interests of the depositors or the public to permit the association to employ the individual.

#### *Prompt Corrective Action*

Undercapitalized and significantly undercapitalized associations that fail to submit and implement an acceptable capital restoration plan are subject to the prompt corrective action provisions of § 38(f)(2)(F) of the FDIA. That section permits OTS to dismiss any director or senior executive officer who held office for more than 180 days immediately before under-capitalization. The section also requires the association to employ qualified senior executive officers. Section 38(i)(2)(f) of the statute requires OTS to take action to prohibit critically undercapitalized associations from paying excessive compensation or bonuses.

Also, the prompt corrective action provisions of OTS regulation 12 CFR §565.6(a) impose restrictions on management fees and senior executive officer compensation. Undercapitalized, significantly undercapitalized, and critically undercapitalized savings associations are subject to the management fee provisions of § 38(d) of the FDIA. Significantly undercapitalized and critically undercapitalized associations are subject to the senior executive officer compensation provisions of § 38(f)(4).

Section 38(d)(2) of the FDIA prohibits associations from paying a management fee to any person having control of the association if after the payment the association would be undercapitalized. Section 38(f)(4) provides that undercapitalized or significantly undercapitalized associations that fail to submit and implement an acceptable capital restoration plan shall not do either of the following without prior OTS approval:

- Pay a bonus to a senior executive officer.
- Compensate a senior executive officer at a rate exceeding the officer's average rate of compensation for the year prior to the month when the association became undercapitalized.

#### *Safety and Soundness and Compensation Standards*

Appendix A of 12 CFR Part 570, entitled Inter-agency Guidelines Establishing Standards for Safety and Soundness, sets forth operational and

managerial standards for insured associations to follow with respect to the following activities and practices:

- Internal controls and information systems
- Internal audit systems
- Loan documentation
- Credit underwriting
- Interest rate exposure
- Asset growth
- Asset quality
- Earnings
- Compensation, fees, and benefits.

The compensation guidelines require associations to maintain safeguards to prevent the payment of compensation, fees, and benefits that are excessive or that could lead to material financial loss to the association. The guidelines define compensation to be excessive when it is unreasonable or disproportionate to the services that an executive officer, employee, director or principal shareholder performs, in consideration of the following factors:

- The combined value of all cash and non-cash benefits provided to the individual.
- The compensation history of the individual and other individuals with comparable expertise at the association.
- The financial condition of the association.
- Comparable compensation practices at comparable associations.
- For post-employment benefits, the projected total cost and benefit to the association.
- Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the association.

- Any other factors the federal banking agencies determine to be relevant.

Section 570.2(b) provides that if OTS determines that an association fails to meet a safety and soundness standard, OTS may request the submission of a safety and soundness compliance plan.

Regulatory Bulletin 27a provides compensation provision guidance and clarifies OTS policy about unsafe and unsound practices relating to executive compensation and employment contracts.

### Planning

Sound planning is fundamental to effective management and is a key to anticipating and dealing with rapid change. Senior management and the board of directors should inventory the association's resources, examine changes in its operations, and determine its responses to those changes. To be effective, planning should be dynamic in nature. The savings association should carefully monitor and support the planning function. Management must revise projections periodically as circumstances change and the board formulates new strategies to meet stated objectives.

Planning requires the collection and coordination of large amounts of information and the thoughtful efforts of all members of the management team. Written plans help ensure that the board of directors, executive officers, and all division managers within the association share the same goals, objectives, and strategies. A common and shared perception of future actions is critical to the execution of a successful plan.

Any of the following management failures warrants the attention of the association's directors. You should accordingly note such failures in the report of examination:

- Lack of a satisfactory planning process.
- Lack of adherence to plans.
- Ineffective monitoring and control of plans.
- Failure to adjust existing plans to recognize and conform to changing economic and market conditions and requirements.

You should also be alert, particularly with respect to new associations, for any deviations to strategic or operational plans that may be potentially detrimental to the association. Such deviations, which you should also note in the report of examination when assessing management performance, include the following examples:

- The excessive use of or reliance on brokered deposits.
- The initiating of new, novel, or higher risk lending or investment programs without appropriate planning, experience, or controls.
- The failure to independently and adequately investigate and document extensions of credit, particularly those made outside an association's normal lending territory.
- The willingness to forgo long-term stability in favor of short-term profits.

Many newly chartered savings associations are subject to approval conditions, usually contained in the director's order. You should carefully review the associations adherence to these conditions.

#### *The Planning Process*

To be effective, planning requires a structure and a process. Associations can segment planning into two classifications; strategic and operational. Strategic planning focuses on the long-term, extensive allocation of resources to achieve corporate goals and objectives. Operational planning, such as a business plan, concentrates on shorter-term actions designed to implement those strategies outlined in the strategic planning process. For an effective planning process, the operational plans must flow logically from the strategic plan.

#### *Regulatory Concerns*

You should not evaluate association planning with the preconception that every association should have a model planning process. You should evaluate the planning process and the plan itself. If a well-designed planning process exists, the plan will generally be thoughtful and realistic. Management's failure to have a satisfactory planning process warrants the attention of the association's

directors and you should accordingly report the failure in the report of examination.

You must treat an association's strategic, operational, and business plans with maximum confidentiality. They contain sensitive information that directly affects the association's market position and financial condition.

#### **Management of Human Resources**

People are the link between an association's organizational structure and the attainment of its organizational goals. The board of directors is responsible for employing a competent chief executive officer. Thereafter, senior management is responsible for recruiting and making certain that there are competent employees available to staff all positions. Personnel management includes establishing procedures for promoting and replacing employees, reviewing their performance, devising a system of compensation, and selecting and training future managers.

The following areas warrant your particular attention in evaluating personnel management, as they are important indicators of an association's viability:

- Detailed position descriptions and standards.
- Carefully planned recruiting and proper screening of new employees.
- Appropriate training.
- Performance review and comparison to standards.
- Salary administration.
- Provision for communication.

You should determine the appropriateness of an association's employment contracts, bonus and incentive plans, salary levels, and employee benefits program. You should compare compensation paid and benefits provided with those that an appropriate peer group offers, and should determine reasons for any substantial differences.

#### *Use of Consultants and Outsourcing*

It is fairly common for savings associations to outsource certain functions of the association. Outsourcing functions can reduce operating expenses; however, associations should be careful not to rely on vendors or consultants to perform critical functions without adequate controls. Use of a vendor or consultant does not lessen the burden on management to supervise and control the association's systems, policies and procedures. The savings association must have a written agreement with the vendor or consultant that outlines the conditions, rights, and responsibilities of each party.

### Management Succession

You should evaluate the association's quality of plans for maintaining its present condition and for improving its future condition. This should include an evaluation of the board's and management's efforts to provide for succession of senior officers.

The projection of future management needs involves an appraisal of the quality and quantity of senior and middle management. This assessment must be relative to the size, complexity, and market circumstances of the association. Determination of what management will do with the association in the future is most important. The supervisory goal is to prevent problems from developing rather than wait for future examinations or monitoring to identify deteriorating conditions.

### Management Information Systems

An effective management information system (MIS) contains information from a number of sources. Such information must serve a number of users, each having varying needs. The MIS must selectively update information from all available sources and coordinate it into meaningful and clear formats. You can determine the effectiveness of MIS on the bases of the following measurements:

- **Quality.** This relates to the relevance and accuracy of the information. Poor quality information usually stems from inadequate controls, analysis, and evaluations of information needs, or from ineffective design of reports.
- **Quantity.** Too many reports or too much information on a single report may hamper or

discourage their use completely. Too little information may reflect insufficient analysis of information needs.

- **Timeliness.** The improper design of information processes and the failure to identify the frequency of need for information usually causes untimely processing and distribution of information.

### Response to Supervision

You must determine the association's compliance with conditions of approval, orders, supervisory agreements, and directives. Supervisory authorities look to management to implement corrective action in response to directors' requests and regulatory supervision requirements. Management should establish procedures to ensure continuing compliance. Corrective action must be responsive to the cited criticism and implementation of appropriate action must be timely. Management must explain any noncompliance with supervisory requirements, including plans for corrective action.

If management or the board of directors continues to operate in an unsafe and unsound manner, supervision may have to initiate formal enforcement action. See Handbook Section 370, Enforcement Actions. Your regional Confidential Individual Information System (CIIS) administrator should record the inclusion of any formal enforcement action against an individual in CIIS. The following are some other types of management or director's actions that your CIIS administrator should record in CIIS:

- Criminal referrals.
- Referrals to a professional group for disciplinary purposes.
- Significant business transactions between an association and an individual that raises supervisory concern.

You should contact your regional CIIS administrator for guidance as to whether a particular event warrants an individual's inclusion in CIIS.

### Avoidance of Conflicts of Interest

The phrase conflict of interest refers to any situation where the safety and soundness or opportunity of an association is in conflict with the personal interests of any of the following persons:

- A director.
- An officer.
- Any other employee or person who has influence over an association's policies, procedures, or actions.

Conflicts of interest (or even the appearance of such) can adversely affect an association's profitability and reputation for integrity. Conflicts can undermine public confidence in the thrift industry.

Sometimes those who owe a fiduciary duty to an association subtly disguise a conflict, making it difficult to detect. In other instances, they may openly acknowledge a conflict. Some conflicts may be detrimental while others may appear to be beneficial to the association. Where a conflict exists, however, its very appearance alone could damage an association's image. A conflict could cause a financial loss to an association if the individual involved considers self-interest and personal gain more important than an association's interests.

Management has a fiduciary responsibility to avoid any conflicts of interest or appearance of conflict of interest. Personal affiliations should not be incompatible with those of the association. Furthermore, when both of the following circumstances exist, no officer should take advantage of a business opportunity for his or her own or another person's personal benefit:

- The opportunity is within the corporate powers of an association or its service corporation(s).
- The opportunity is of present or potential advantage to the association.

You should review the association's formal policy for avoidance of conflict of interest situations. The policy at a minimum should address the following concerns:

- Areas where conflicts of interest and usurpations of corporate opportunity could arise. This includes transactions involving the association and persons related to directors or officers, or transactions for their benefit.
- Controls that the association maintains to avoid abuses and the procedures in place for dealing with policy violations.
- Business activities in which the association's directors and senior management are active.
- Business activities that the law permits the association to conduct.
- A specific plan for dealing with conflicts of interest and corporate opportunity problems in these areas.

You should determine if directors and officers are complying with the policy. Accordingly, you should comment on and take appropriate action on any actual or apparent conflict of interest transactions that adversely affects the association, even though an OTS regulation may not specifically address the conflict. Also, you should include comment, and supervisory objection taken, whenever any person involved in the conflict participates in the approval of the subject transaction.

### *Loans to Executive Officers*

You should have knowledge of both Federal Reserve Board Regulation O, 12 CFR Part 215, and OTS regulation 12 CFR § 563.43. Regulation O governs member bank extensions of credit to executive officers, directors, and principal shareholders. Section 563.43 applies the Regulation O restrictions to savings associations. See Handbook Section 380, Transactions with Affiliates and Insiders.

### Management Questionnaire

The Preliminary Examination Response Kit (PERK) Management Questionnaire is an important and useful tool in determining objectives and strategies for conducting an examination. In this regard, much of the information that the questionnaire asks for may provide leads in determining the

existence of possible conflict of interest situations or transactions. The Management Questionnaire deals with transactions or arrangements with affiliates or affiliate persons, tie-in arrangements, and ownership and control concerns.

You must satisfy yourself as to the completeness and accuracy of responses to the Management Questionnaire, and must follow up on and report any inconsistencies between the responses and your examination findings.

### Internal Controls

Both the directors and senior management have important roles in an association's programs of internal control, loan review, and internal audit. Although directors have overall audit responsibility and should require that the auditor report directly to them, directors normally charge senior management with the duty of developing and maintaining a strong system of internal controls. Relying on the independent auditors to establish the association's internal controls is inappropriate. Senior management is responsible for the design and implementation of effective controls to prevent errors, conflict of interest situations, and fraud. Refer to Sections 340, 355, and 360 of this handbook.

### Fidelity Bonds and Directors' and Officers' Liability Insurance

Fidelity bond coverage insures against losses attributable to dishonest acts. Directors' and officers' liability insurance covers losses attributable to negligent acts.

Under 12 CFR § 563.190, Bonds for Directors, Officers, Employees, and Agents; Form of and Amount of Bonds, associations must maintain bond coverage. Coverage must be in an amount that each association determines to be safe and sound in view of the association's potential exposure to risk. In assessing the adequacy of such coverage, management and the board of directors should at a minimum consider the following factors:

- The size of the association's asset portfolio and deposit base.

- An overall assessment of the effectiveness of the association's internal operating controls.
- The amount of cash, securities, and other property that the association normally holds.
- The number of the association's employees, their experience, levels of authority, and turnover rate.
- The extent that the association conducts trust powers or EDP activities.
- The extent of coverage that a holding company fidelity bond or other affiliated entity provides.

During the examination process you are to review the record of management's assumptions, analyses, and conclusions in its determination as to the appropriate form and levels of coverage.

OTS regulations do not require fidelity bond coverage under a specific standardized form. Bond coverage must include each director, officer, employee, and agent who has control over or access to cash, securities, or other property of the association. The board of directors of each association must formally approve the association's coverage, including any endorsements, riders, or other forms of coverage that may supplement the insurance underwriter industry's standard forms.

In addition, an association doing business with a stockbroker must ensure that the stockbroker has Stockbroker's Blanket Bond protection. This protection covers the firm's employees that handle the property of clients. The association should keep a copy of the bond in its files.

For various reasons, such as insufficient levels of regulatory capital, some associations have difficulty in obtaining bond coverage. Supervisory discretion is permissible in these instances when an association documents evidence of its attempts to obtain coverage. The association should notify the regional director of its efforts to obtain such coverage.

An association's periodic review of internal and external security measures and controls is appropriate in every association. See the Compliance Activities Handbook Section 405, Bank Protection Act. Such review is especially appropriate in an

association that is operating without adequate bond coverage. Ideally, an association should undertake this effort as a special project, with responsibility assigned to a particular executive officer. The project should include such matters as the following:

- A thorough review of the association’s existing programs.
- The design and implementation of additional security procedures and controls.
- A formal report to the board of directors. The board’s minutes should note the board’s resulting action.

Paragraph (d) of 12 CFR §563.190 requires the board of directors to review the association’s bond coverage at least annually to assess the continuing adequacy of coverage.

In addition to fidelity bond coverage, many associations obtain directors’ and officers’ (D&O) liability insurance. D&O insurance protects directors and officers against personal liability for losses that a third party incurred due to a director or officer’s negligent performance.

There is no regulatory requirement that an association maintain D&O insurance. A federal association may self-indemnify directors and officers.

**REFERENCES**

**United States Code (29 USC)**

- § 201 Fair Labor Standards Act of 1938
- § 206 Equal Pay Act of 1963
- § 621 Age Discrimination in Employment Act of 1967
- § 651 Occupational Safety and Health Act of 1970
- § 1001 Employee Retirement Income Security Act of 1974

**United States Code (42 USC)**

- § 2000e Title VII of the Civil Rights Act of 1964 (Equal Employment Opportunity)

**Code of Federal Regulations (12 CFR)**

*Federal Reserve Board Regulations*

- Part 215 Regulation O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks

*OTS Regulations*

- § 528.7 Nondiscrimination in Employment
- § 545.121 Indemnification of Directors Officers and Employees Officers
- § 552.6-2 Officer
- § 561.35 Directors, Officers, and Employees
- § 563.33 Employment Contracts
- § 563.39 Loans and Other Transactions with Affiliates and Subsidiaries
- § 563.41 Loans by Savings Associations to Their Executive Officers, Directors and Principal Shareholders
- § 563.161 Management and Financial Policies
- § 563.180 Suspicious Activity Reports and Other Reports and Statements
- § 563.181 Reports of Change in Control of Mutual Savings Associations
- § 563.183 Reports of Change in Chief Executive Officer or Director
- § 563.190 Bonds for Directors, Officers, Employees, and Agents; Form of and Amount of Bonds
- § 563.191 Bonds for Agents
- § 563.200 Conflicts of Interest
- § 563.201 Corporate Opportunity
- § 563.550 Notice of Change of Director or Senior Executive Officer
- Part 563f Management Official Interlocks
- § 565.6 Mandatory and Discretionary Supervisory Actions under Section 38

**Office of Thrift Supervision Bulletins**

- RB 20      Proper Investigation of Applicants  
                 and Increased Communications  
                 Between OTS and Other Financial  
                 Association Regulatory Agencies
- RB 27a     Executive Compensation

**FFIEC Interagency Policy Statement**

Interagency Policy Statement on the Internal Audit  
Function and Its Outsourcing

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# Management Assessment Program

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## Examination Objectives

To determine whether management policies, procedures, and strategic plans adequately address safety and soundness, profitability, and compliance with laws and regulations.

To determine whether association officers are operating in conformance with established guidelines, objectives, policies, and procedures.

To ascertain whether management personnel periodically re-evaluate procedures and practices and implement appropriate modifications, either directly or through recommendations to the board of directors.

To determine whether management plans adequately for future conditions and developments.

To determine whether the association has policies to ensure an adequate management staff, and has adequate plans for management continuity.

To determine the adequacy of the staff size and expertise for safe operations.

To determine if management adequately controls and supervises the outsourcing of functions and the use of consultants.

## Examination Procedures

Wkp.Ref.

### Level I

1. Review previous examination reports, audit reports, management letters, related correspondence, and any approval conditions. Perform any necessary follow-up procedures.

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2. Review the following records.

- Organization chart. Identify key decision-making personnel (include copy in the continuing examination file).
- Resumes and new employment contracts and executive incentive plans for executive officers and department or division head. The review should also cover any changes since the last examination.
- Conflict of interest policy. Determine if the policy ensures regulatory compliance and whether management distributes the policy to directors, officers, and employees.
- Management's responses to the PERK Management Questionnaire.

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- Details regarding outsourcing arrangements and the use of consultants.
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3. Determine whether there are any changes in the association's management or directorate and, if applicable, whether the association is in compliance with the notification requirements of 12 CFR §§ 563.550 through 563.590. Notify the regional director if the association is not in compliance.

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4. Analyze the following types of periodic reports submitted to executive management to determine their usefulness in monitoring the condition and operation of the association:

- Financial condition reports.
  - Business and strategic plans, budgets, and comparison of performance with budget reports.
  - Internal audit and loan review reports.
- 

5. Review the fidelity bond and directors' and officers' insurance policies and determine if coverage is adequate.

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6. Determine whether management is committed to comply with conditions of approval, orders, supervisory agreements, and directives, if applicable to the association or holding company.

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7. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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### Level II

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8. Complete General Questionnaire 330, Management Assessment.

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9. Through the review of gathered information, including observations and discussions with management and other personnel, determine the adequacy of the following operational concerns:

- The association's established policies, procedures, and strategic plans that address safety and soundness (including internal controls), profitability, and compliance with laws and regulations.
  - Management's expertise and ability to carry out duties and responsibilities, including corrective actions, in a manner that provides for an acceptable level of safety and soundness, profitability, and compliance with laws and regulations.
  - Management reports and information systems. The reports and systems must provide management and the directors with accurate decision-making information and the ability to monitor compliance with established guidelines.
- 

10. Review and evaluate management compensation to assure that it is adequate and not excessive.

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11. Determine whether the association has established any executive incentive plans. If so, determine if such plans could lead to the deterioration of the association's condition or allow beneficiaries of the plan to understate noncash expenses or overstate noncash income. Incentive plans include commissions, referral fees, finder fees, bonus plans, deferred compensation packages, stock option plans, and extravagant fringe benefits.

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12. In conjunction with the examiners assigned to the Earnings and Liquidity areas, determine if the association's strategic planning is adequate. Consider the following questions:

- Does the board of directors provide adequate direction?
- Is the strategic plan realistic based on the association's strengths and weaknesses, and operating environment?

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- Are the assumptions of the plan realistic?
  - Are there sufficient performance measures designed to monitor progress toward specified objectives? Review progress against plan goals.
  - Does the strategic plan include a clear mission statement?
  - Does management effectively communicate the plan throughout the organization?
- 

13. Review the association's activities with regard to developing personnel for senior management succession. At a minimum, this review should include the following considerations:

- An assessment of the quality of middle and lower levels of management and the potential for advancement.
  - An assessment of the need for and access to developmental training.
  - An assessment of the association's employee screening policies to determine that they are appropriate to protect the safety and soundness of the association.
- 

14. When appropriate, interview the personnel manager to determine answers to the following concerns:

- What personnel policies are currently in effect, and is their application equitable and uniform to all deserving employees?
  - How does the association communicate policies to employees?
  - Are procedures in place to eliminate terminated employees access to assets and records?
- 

15. Determine the structure of the association's communication system, both formal and informal, and the extent to which the association adequately informs personnel of strategic goals, policies, and procedures.

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## Management Assessment Program

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16. Review records and reports that summarize employee turnover, and interview management personnel and employees. Determine reasons for excessive turnover, if applicable.

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17. Ask the managing officer or personnel officer if any employees or former employees have brought any discrimination complaints, lawsuits, workers compensation claims, unemployment claims, or wrongful discharge suits against the association during the review period. Compare the responses with the answer in the Management Questionnaire.

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18. If appropriate, further evaluate management based on your above Level I and II findings and work performed throughout the examination. Consider the following factors:

- The workload of key personnel.
  - Succession of management and replacement of key personnel.
  - Technical proficiency of officers in their areas.
  - Serious or widespread lack of proper implementation of policies.
  - Deficiencies in the planning process, the strategic plan or its implementation.
  - Promptness with which management recognizes and addresses problems.
  - The extent to which management delegates and demands accountability.
  - Whether management pays more attention to the operations of a functional area rather than with the overall supervision of the association.
  - The degree to which the association is self-regulating, for example, the sufficiency of its systems, such as internal audit and loan review.
  - The appearance of any conflict of interest situations.
  - The overall effectiveness of management based on the association's performance.
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## Management Assessment Program

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19. Ensure that your review meets the *Examination Objectives* of this Handbook section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate workpapers and report pages.
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### Level III

20. Review written personnel manuals, job descriptions, new employee orientation manuals, and training manuals for employees and supervisors. Determine if manuals and related information are reasonable and in compliance with the provisions of current law and regulations concerning discrimination. Determine whether they include logical and adequate detail with respect to work flows, lines of authority, and areas of job responsibility. Look for any disparate treatment in hiring practices, test requirements, or screening opportunities.
- 

21. Determine whether the association periodically reviews employee performance, analyzes weaknesses, takes corrective action when appropriate, and has specific policies and procedures for handling employees who have demonstrated incompetence or nonperformance.
- 

22. Review a selected sample of personnel files. Determine whether the association's procedures provide for the systematic updating of personnel files and whether the staff updates in accordance with the schedule. Determine whether the files contain the following information:

- Payroll deduction authorizations that comply with state and federal laws.
  - Records of accumulated withholdings.
  - Notations of length of service, salary history, and retirement and other accrued benefits.
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**Prepared By:** \_\_\_\_\_  
**Reviewed By:** \_\_\_\_\_  
**Docket #:** \_\_\_\_\_

## Management Assessment Questionnaire

	Yes	No		Yes	No
<b>General Questionnaire</b>					
1. Has the board set overall objectives for management performance and has management met the objectives? .....			5. Does the auditing function cover officers' compliance with board and management policies? .....		
2. Does the institution have an organizational chart? If not, have lines of authority and reporting responsibility been formally established? .....			6. Does the association have policies to ensure the continuity of development and depth of management personnel? .....		
3. Does senior management receive:			7. Is the staff adequate to facilitate efficient operations? .....		
• A brief statement of condition daily? .....			8. Does the institution comply with applicable statutes, regulations, and policy statements? .....		
• A daily liquidity report? .....			9. Does the institution use a system of written job descriptions and performance standards, including descriptions for supervisory personnel? .....		
• A list of assets subject to internal classification at least monthly? .....			10. Does the institution perform background investigations on new employees? .....		
• A comparative earnings statement, at least monthly? .....			11. Does the association have a formal training program? .....		
4. Does management periodically review the institution's implementation and maintenance of internal controls (generally through reports that the internal or external auditors provide)? If so, has management determined whether controls:			12. Does the association provide management training to those persons likely to assume higher level positions? .....		
• Adequately prevent irregularities by the use of limited authorities, co-approval requirements, and prompt review of transactions for required approvals, as well as propriety? .....			13. When appropriate, do employment termination procedures prevent a terminated employee's ability to control assets and records, eliminate passwords, change locks, remove signature authorities, and provide proper termination notifications to affected employees? .....		
• Adequately deters irregularities by ensuring their timely detection? .....			14. If the institution was or is subject to the notification requirement 12 CFR § 563.550 is the institution in compliance with the regulation? .....		
• Establish and maintain appropriate accountability? .....			15. If the institution is subject to the prompt corrective action provisions of OTS regulation § 565.6(a), is it in compliance with the management fee and executive officer compensation restrictions of FDIA § 38? .....		
• Ensure the maintenance of well-planned records? .....					
• Ensure the segregation of duties? .....					

Exam Date: \_\_\_\_\_  
 Prepared By: \_\_\_\_\_  
 Reviewed By: \_\_\_\_\_  
 Docket #: \_\_\_\_\_



**INTRODUCTION**

A thrift's affiliate relationships and transactions can significantly affect the operations and overall financial condition of a savings association. Your review of a thrift's and its subsidiaries' transactions with its affiliates is a critical component of the thrift and holding company examinations. However, the affiliate transaction rules are complex and, at times, confusing. This section will give you a basic understanding of the rules related to affiliate transactions. You should carefully review these transactions to identify any potential risks they pose to the savings association and ultimately to the deposit insurance fund.

During recent years, as competition among providers of financial services increased, companies pursued opportunities to enhance operating synergies among affiliated entities and to leverage expertise and resources throughout their overall organizational structure. Such relationships can present unique challenges for regulators, for example, in identifying the flow of funds among entities and assessing internal controls for oversight of thrift/affiliate arrangements. OTS's transactions with affiliate rules (§§563.41 and 563.42) (TWA Rules) generally mirror those applicable to banks and serve to limit the risks affiliates present to thrifts.

In many cases, it is appropriate and beneficial for a thrift to engage in business transactions with its affiliates and insiders. OTS, however, may prohibit transactions by regulation or, when contrary to the thrift's best interests, based on safety and soundness grounds and even abuse. Accordingly, you must distinguish appropriate transactions from abusive or potentially abusive transactions, or transactions that are otherwise inconsistent with safe and sound operations.

The thrift's affiliate transactions should meet the following criteria:

- Not be abusive or detrimental to the savings association. (You should be alert to any transaction that subjects the association to un-

reasonable pressure from management or an affiliate.)

- Be based on safe and sound practices.
- Comply with applicable statutory and regulatory standards.

Beyond the TWA Rules, additional regulatory standards set forth in §563.43 limit how much and on what terms a thrift may lend to its own insiders (directors, executive officers, principal shareholders and related interests) and insiders of an affiliate.

This Section should help you evaluate the following areas:

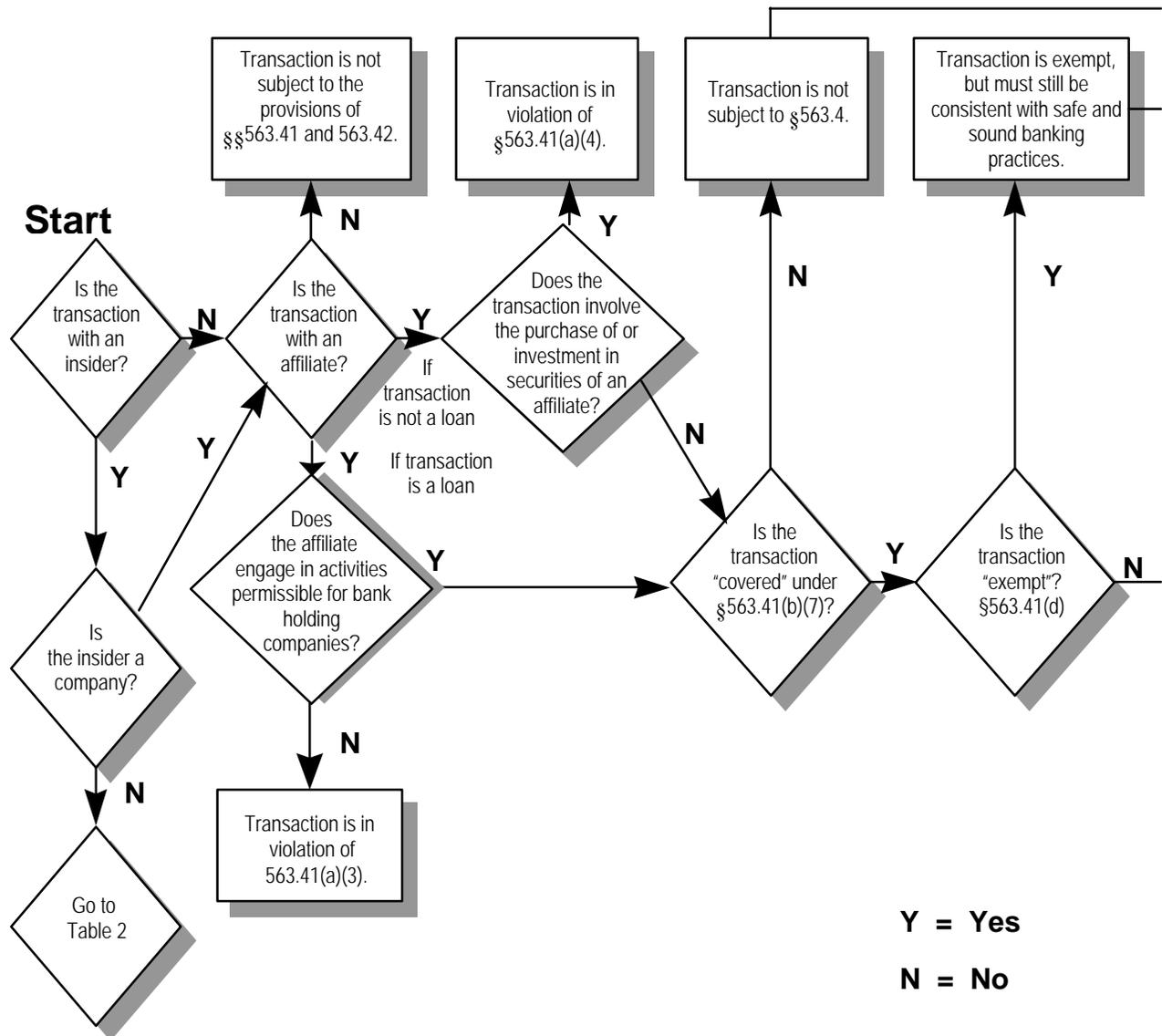
- Acceptability of transactions with affiliates.
- Permissibility of transactions with insiders.

**TRANSACTIONS WITH AFFILIATES**

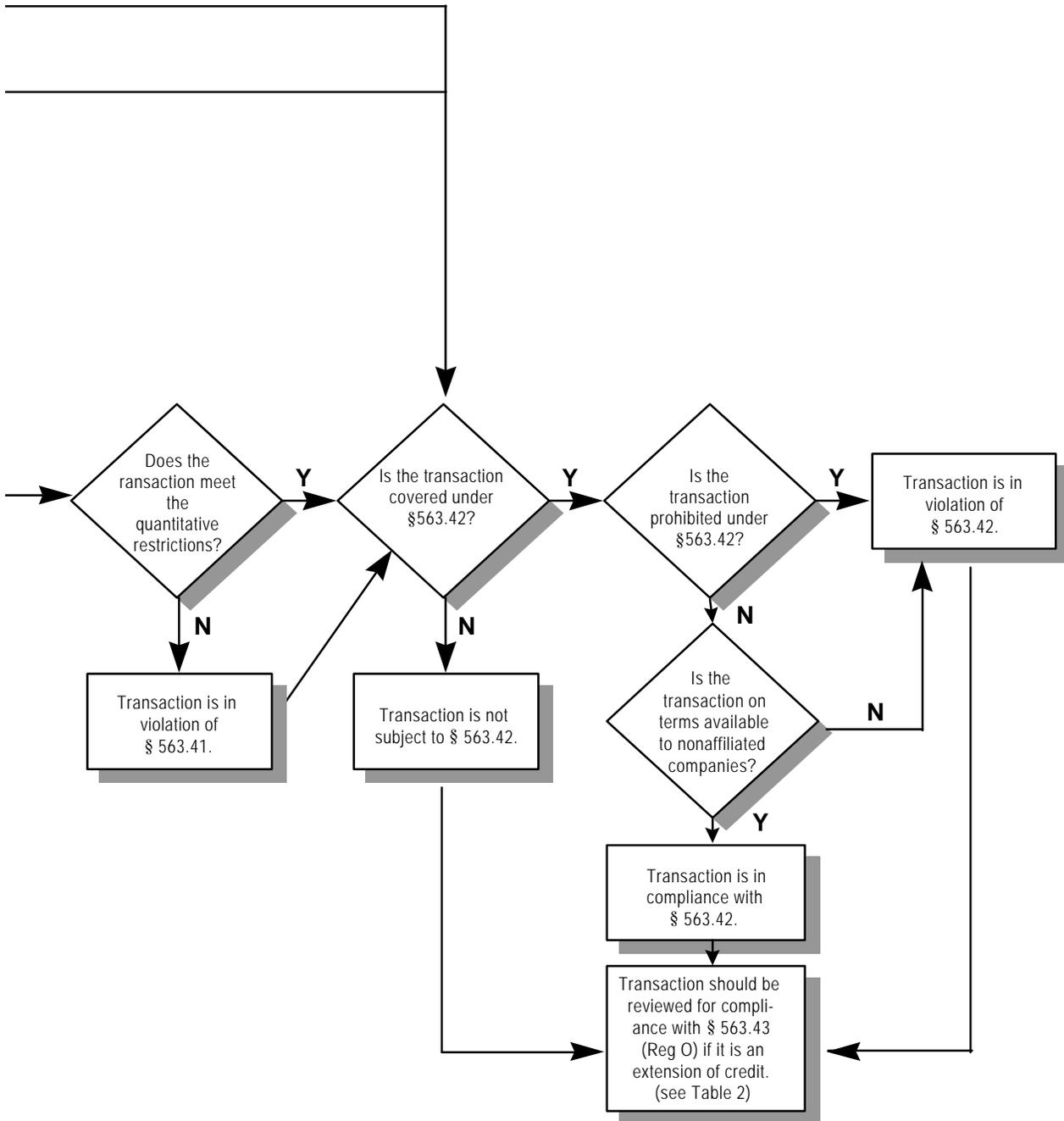
Affiliate transactions occur when an association or its subsidiary engages in a transaction with its holding company, any subsidiary of the holding company, or any other entity or person considered an affiliate. You may find evidence of such transactions at any thrift, but the volume of affiliate transactions is usually greater in a holding company structure since intercompany transactions are often an integral part of a company's operations. Due to the potential risk from these transactions, thrifts are subject to the following regulatory standards:

- Individual and aggregate percentage of capital ceilings on the dollar amount of affiliate transactions.
- Arms-length dealings requirement.
- Prohibition of acquisitions of low-quality assets from affiliates.

**Table 1**  
**Transactions with Affiliates Guidelines**



**Table 1**  
**Transactions with Affiliates Guidelines**



- Collateralization requirements for affiliate credit transactions.
- Prohibition of certain activities.
- Transaction exemption provision.

To help you understand affiliate transactions, the flow chart in Table 1, Transactions with Affiliates Guidelines, presents the following information in a step-by-step manner. Also, you can use Appendix A, Transactions with Affiliates Checklist, to review specific affiliate transactions. The checklist incorporates applicable regulatory standards.

### Compliance with 12 CFR §563.41

You should consider all of the following elements to determine whether a transaction is subject to §563.41:

- Is the transaction with an affiliate?
- Does the transaction qualify as a covered transaction?
- Is the transaction an exempt transaction?
- Does the covered transaction meet the quantitative restrictions?
- Does the transaction meet the qualitative restrictions, including collateral requirements, if it is a loan?

We will review each of these considerations in the following pages.

#### *Is the Transaction with an Affiliate?*

As a first step, identify the thrift's affiliates. The definition of an "affiliate" includes the following entities:

- A company that controls the savings association and any other company it controls.
- A bank or savings association subsidiary of the savings association.

- A company controlled directly or indirectly, by trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the savings association or any company that controls the savings association.
- A company in which a majority of directors, partners, or trustees constitute a majority of the persons holding office with the savings association or any company that controls the savings association.
- A company, including a real estate investment trust, that the savings association or any subsidiary or affiliate of the thrift, sponsors and advises on a contractual basis, or an investment company for which a savings association or any affiliate thereof is an investment advisor as defined in Section 2(a)(20) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(a)(2).
- A company that OTS or the Board of Governors of the Federal Reserve System determines by regulation or order to have a relationship with the savings association or any subsidiary or affiliate such that covered transactions by the savings association or its subsidiary with that company may be affected by the relationship to the detriment of the savings association or its subsidiary.
- A company that OTS determines presents a risk to the safety or soundness of the savings association, based on the nature of the activities conducted by the company, amount of transactions with the savings association or its subsidiaries, financial condition of the company or its parent association, or other supervisory factors.

*Additionally, the thrift should treat any transaction that it or its subsidiary has with any person as a transaction with an affiliate if the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate.*

A company or shareholder has *control* over another company if the company or shareholder meets one of the following criteria:

- Directly or indirectly, or by acting in concert with one or more persons, controls, or has the power to vote, 25 percent or more of any class of voting securities.
- Directly or indirectly, or by acting in concert, controls the company under 12 CFR §574.4(a), or is presumed to control the company under §574.4(b), and the control has not been rebutted.

Additionally, for purposes of the TWA Rules, a subsidiary of a savings association is any company the savings association controls according to Part 574.

In general, OTS does not consider subsidiaries of the savings association as affiliates of the savings association. There are, however, some exceptions to this rule. The following subsidiaries are considered affiliates:

- Bank and thrift subsidiaries of a savings association.
- Any company that is a subsidiary and an affiliate (for example, when a holding company and its thrift own controlling shares of the company).
- Any subsidiary that OTS or the Federal Reserve Board (FRB) may designate an affiliate.

Also, a company is not an affiliate if it meets any of the following criteria:

- Engages solely in holding the premises of the savings association.
- Engages solely in conducting a safe deposit business.
- Engages solely in holding obligations of the United States or its agencies or obligations fully

guaranteed by the United States or its agencies as to principal and interest.

- Comes under control of the thrift as a result of the thrift's exercise of rights resulting from a bona fide debt previously contracted, but only for the period of time specifically authorized under applicable state or federal law or regulation. In the absence of a law or regulation, control may not exceed two years unless OTS grants an extension. Extensions may not exceed one year each and, in the aggregate, may not exceed three years.

If a transaction is not with an affiliate, then the TWA Rules do not apply. Subsidiaries of savings associations that are excluded from the definition of an affiliate are treated as equivalent to the association itself for purposes of the TWA Rules. Thus, an affiliate of the savings association is also an affiliate of that association's subsidiaries. As such, a transaction between a subsidiary of a savings association and the association's holding company or other subsidiaries of the holding company is also subject to the TWA Rules.

#### *Is the Transaction a "Covered Transaction?"*

Once you determine that a transaction is with an affiliate, you must determine if it is a covered transaction. If you answer "yes" to any of the following questions, the transaction is a covered transaction and is subject to the standards in §563.41.

- Has the association or a subsidiary made a loan or extension of credit to an affiliate?

*Note:* Certain less-obvious transactions may constitute the equivalent of extensions of credit or other types of covered transactions. For example, intercompany payable/ receivable transactions, rent subsidies, and use of the thrift's personnel, premises, funds, or equipment without adequate compensation. Generally, if the institution conducts such transactions on an arms-length basis, consistent with how they conduct transactions with a non-affiliated party, OTS does not consider transactions "de facto"

extensions of credit or covered transactions. However, you should review all such transactions to determine whether §563.41 applies and, if so, whether the institution complies with the applicable restrictions. You should also review the transactions for general safety and soundness concerns regardless of whether they are considered extensions of credit.

- Has the association or a subsidiary purchased assets, including assets subject to a repurchase agreement, from an affiliate? Do not include purchases of real and personal property that the FRB specifically exempts through regulation or order.
- Has the association or a subsidiary accepted securities that an affiliate issued as collateral security for a loan or extension of credit to any person or company?
- Has the association or a subsidiary issued a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate?

*Congress enacted two specific prohibitions in the Home Owners' Loan Act (HOLA) that are more restrictive than sections 23A and 23B of the FRA. Congress added these prohibitions to reflect the fact that affiliates of savings associations can engage in a far greater range of activities than affiliates of banks, and can thus expose the savings association to greater risks. The TWA Rules prohibit two types of transactions:*

- Purchasing or investing in securities of any affiliate other than in shares of a subsidiary.
- Making a loan or extension of credit to any affiliate unless such affiliate is engaged solely in activities described in HOLA 12 USC 1467a(c)(2)(F)(i) as defined in 12 CFR §584.2-2 (permissible bank holding company activities).

For the purpose of this restriction, a loan or other extension of credit includes a purchase of assets from an affiliate that is subject to the affiliate's

agreement to repurchase the assets unless the affiliate meets the specific criteria outlined in 563.41(a)(3).

In determining whether HOLA prohibits a loan to an affiliate, you should attribute the activities of each subsidiary company to its parent company in a vertical chain up to, but not including, a controlling savings and loan holding company. However, loans to a "sister" thrift or bank are permissible regardless of the types of activities in which the sister thrift's service corporation engages.

Even if a transaction is not a covered transaction under §563.41, it may still be subject to the requirements of §563.42. In addition, some affiliate transactions may be exempt from §563.41.

#### *Is the Transaction Exempt?*

Although an affiliate transaction satisfies the definition of a covered transaction, an exemption may nevertheless apply. Exempt transactions are generally not subject to the quantitative or qualitative restrictions imposed on covered transactions. However, §563.41(a)(6) requires all covered and exempt transactions to be on terms and conditions consistent with safe and sound banking practices. The following transactions are exempt from §563.41:

- After January 1, 1995, any transaction with a savings association or a bank:
  - That controls 80 percent of the voting shares of the savings association;
  - In which the savings association controls 80 percent or more of the voting stock; or
  - In which 80 percent or more of the voting shares are controlled by the company that controls 80 percent or more of the voting shares of the savings association.

*Note:* These transactions are subject to the low-quality asset provision.

- Making deposits in an affiliated bank, thrift, or affiliated foreign bank in the ordinary course of correspondent business, subject to any restric-

tions that OTS or FRB may prescribe by regulation or order.

- The granting of immediate credit to an affiliate for uncollected items received in the ordinary course of business.
- The making of a loan or extension of credit to, or issuing a guarantee, acceptance, or letter of credit on behalf of, an affiliate that engages solely in activities permissible for bank holding companies, provided the institution fully secures the transaction with one of the following:
  - obligations issued or fully guaranteed as to principal and interest by the U.S. or its agencies.
  - a segregated, earmarked deposit account with the savings association.
- The purchase of assets having a readily identifiable and publicly available market quotation and purchased at that market quotation.

*Note:* To be eligible, the institution must establish asset value according to the market-at-large, such as stocks listed on a major stock exchange. Market quotations must appear regularly in a widely disseminated news source, such as the Wall Street Journal. Asset purchases based on Fannie Mae and Freddie Mac mortgage purchase quotations do not qualify.

- The purchase of loans on a nonrecourse basis from an affiliated bank or savings association subject to the prohibition on purchasing low-quality assets set forth in §563.41(a)(5).
- The purchase from an affiliate of a loan or extension of credit that the savings association originated and sold to the affiliate subject to a repurchase agreement or with recourse.

*In addition to these exemptions, FRB issues interpretive rulings that may create additional exemptions from §23A. The FRB created an exception for certain loan purchases at 12 CFR §250.250. This exemption applies to a thrift's pur-*

chase from an affiliate of whole mortgage loans or participations, within the context of a specific proposed transaction or series of transactions, on a non-recourse basis, before the affiliate committed to make the loan. In such cases, the thrift must conduct its own independent evaluation of the borrower's creditworthiness before it commits to purchase the loans or participations.

OTS views as unsafe and unsound a blanket advance commitment by an association to purchase a set amount of loans not attributed to a specific proposed transaction unless the commitment is conditioned upon the loans complying with the TWA Rules. Also, the exemption does not apply where loan purchases by the thrift constitute the primary source of funding for the affiliate's lending operations or the funds alleviate the affiliate's working capital needs. To determine whether loan purchases represent an eligible participation arrangement or an ineligible financing transaction, you must assess other sources of credit or funding used by or available to the mortgage banking affiliate and the volume of purchases by the thrift in relation to the affiliate's overall production and profits. Further, the §250.250 exemption may not be available when the thrift invests a substantial percentage of its capital in loans originated by an affiliate.

If a transaction with an affiliate is covered under §563.41, but is not exempt, it is subject to the TWA Rules.

#### *Does the Covered Transaction Meet Quantitative Restrictions?*

Any covered transaction with an affiliate that is not exempt is subject to certain quantitative restrictions. Through a review of internal records, you should verify that the association's and its subsidiaries' aggregate amount of covered transactions are within both of the following quantitative limits:

- 10 percent of the association's capital stock and surplus with any single affiliate.
- 20 percent of the association's capital stock and surplus with all affiliates.

Institutions should attribute transactions with third parties in which the proceeds benefit an affiliate to that affiliate for purposes of calculating compliance with the quantitative restrictions described above.

The institution should value “hard” assets, such as building and office equipment at their cost, minus depreciation. The institution should include amortizing assets, such as loans, in decreasing amounts as they amortize. When assets purchased are subsequently sold, the institution should subtract them from the balance of its covered transactions with the affiliate from which the asset was purchased, and from the overall total of transactions with affiliates.

The institution should attribute the dollar amount of transactions with a subsidiary company to a parent company in a method similar to the manner described for activities above. For purposes of these restrictions, the institution should attribute transactions to each parent in a vertical chain, up to, but not including a controlling savings and loan holding company.

#### *Does the Covered Transaction Meet Qualitative Restrictions?*

Covered transactions are also subject to certain qualitative restrictions. A covered transaction may not include a low-quality asset and must be on terms and conditions consistent with safe and sound banking practices. A low-quality asset may include any of the following:

- An asset classified as substandard, doubtful, loss, or special mention in the most recent report of examination or inspection.
- An asset in a nonaccrual status.
- An asset on which principal or interest payments are more than 30 days past due.
- An asset with renegotiated or compromised terms due to the deteriorating financial condition of the obligor.

An association may purchase a low-quality asset from an affiliate if the association, pursuant to an independent credit evaluation, committed itself to

purchase the asset prior to the acquisition of the asset by the affiliate.

If a savings association lends or extends credit to an affiliate in a covered transaction, the transaction must be adequately collateralized in accordance with the requirements of §563.41(c). The thrift must obtain security for each loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of, an affiliate. The collateral must have a market value equal to one of the following:

- 100 percent of the amount if the collateral is composed of:
  - Obligations of the United States or its agencies.
  - Obligations fully guaranteed by the United States or its agencies as to principal and interest.
  - Notes, drafts, bills of exchange or bankers’ acceptances that are eligible for rediscount or purchase by a Federal Home Loan Bank or Federal Reserve Bank.
  - A segregated, earmarked deposit account with the savings association.
- 110 percent of the amount if the collateral is composed of obligations of any State or political subdivision of any State.
- 120 percent of the amount if the collateral is composed of other debt instruments, including receivables.
- 130 percent of the amount if the collateral is composed of stock, leases, or other real or personal property.

You should verify compliance with these requirements through a review of the loan and the types and levels of collateral established and maintained. The affiliate must replace collateral that is subsequently retired or amortized with additional eligible collateral where needed to keep the percentage of the collateral value relative to the amount of the outstanding loan or extension of credit equal to the

minimum percentage required at the beginning of the transaction. An affiliate cannot collateralize a loan or extension of credit, guarantee, acceptance, or letter of credit issued to, or on behalf of an affiliate, with a low-quality asset. Similarly, the affiliate cannot use securities issued by itself or another affiliate as collateral.

Section 563.42 of the TWA Rules contains additional qualitative provisions. All transactions covered under §563.41 are automatically covered under §563.42. In addition, §563.42 expands coverage to a broader base of transactions. Thus, some transactions that are not covered under §563.41, may in fact be covered by §563.42.

### Compliance with the Provisions of §563.42

In addition to a review of affiliate transactions to determine compliance with §563.41, you must determine whether transactions comply with the restrictions of §563.42. To make this assessment, you should consider the following factors:

- Is the transaction with an affiliate?
- Does it involve a covered transaction?
- Does the transaction meet qualitative restrictions?
- Does §563.42 prohibit the transaction?

#### *Is the Transaction with an Affiliate?*

For purposes of reviewing a transaction under §563.42, the term affiliate has the same meaning given in §563.41, with one significant exception. The term affiliate does not include any bank or any savings association. This exclusion is tantamount to a type of “sister bank” exemption, but is broader than the sister bank exemption under §563.41 because there is no percentage-of-ownership test. Therefore, it is possible that a transaction between a savings association and an affiliated bank or savings association may be covered under §563.41 because the 80 percent ownership criteria for the sister bank exemption is not met. However, the transaction may not be subject to §563.42.

#### *Is the Transaction a Covered Transaction?*

A covered transaction under §563.42 includes the following transactions:

- A covered transaction under §563.41.
- A sale of securities or other assets to the affiliate including assets subject to a repurchase agreement.
- A payment of funds or the furnishing of services to the affiliate under contract, lease or otherwise.
- A transaction in which an affiliate acts as an agent or broker or the affiliate receives a fee for its services to the thrift or any other person.
- A transaction with a third party when the affiliate has a financial interest, or is a participant, in the transaction or a series of transactions.

*Also, the association or its subsidiaries should treat any transaction with any person as a transaction with an affiliate if the proceeds from the transaction are used for the benefit of, or transferred to, the affiliate.*

#### *Does the Transaction Meet Qualitative Restrictions?*

If a transaction is a covered transaction, it must take place on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the association or its subsidiary, as those prevailing at the time for comparable transactions with nonaffiliated companies. In the absence of comparable transactions, the transaction must be on terms that, in good faith, would be offered to or would apply to nonaffiliated companies.

#### *Does §563.42 Prohibit the Transaction?*

OTS prohibits certain affiliate transactions altogether. Under §563.42, a thrift or its subsidiary cannot conduct any of the following transactions:

- Purchase, as fiduciary, any securities or other assets from the affiliate unless the purchase is permitted under the instrument creating the fi-

duciary relationship, by court order, or by law of the jurisdiction governing the fiduciary relationship.

- Purchase or acquire, whether as principal or fiduciary, during the existence of any underwriting or selling syndicate, any security where a principal underwriter of the security is an affiliate of the thrift (unless a majority of the thrift's independent directors approves the purchase or acquisition of such securities before they were initially offered for sale to the public).
- Advertise or enter into any agreement stating or implying that the thrift is in any way responsible for the obligations of affiliates. Nor can the affiliate make any such representation in its advertising or otherwise.

#### Compliance with Recordkeeping Requirements

A thrift and its subsidiaries must retain records that reflect their transactions with any affiliate or any unaffiliated party to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate. At a minimum, the records must meet the following requirements:

- Identify the affiliate.
- Indicate the dollar amount of the transaction. Show that the amount is within the applicable quantitative limitations specified in §563.41 or that the transaction is not subject to those limitations.
- Indicate whether the transaction involves a low-quality asset.
- Indicate the type and amount of any collateral involved in the transaction and that the collateral complies in all respects with the collateral requirements in §563.41(c) or demonstrate that the transaction is exempt from these requirements.

- Demonstrate that the terms and circumstances of the transaction comply with the standards in §563.42.
- Show that loans and extensions of credit to affiliates are only made to affiliates that engage solely in activities permissible for bank holding companies.
- Be readily accessible for examination and other supervisory purposes.

#### Compliance with Prior Notification Requirements

A savings association and its subsidiaries may have to notify OTS of transactions with affiliates if any of the following conditions are present:

- A de novo savings association that commenced operations within the last two years.
- An association or holding company thereof that has been the subject of an application or notice under Part 574 approved during the preceding two year period.
- A savings association in any of the following categories:
  - Has a composite CAMELS rating of 4 or 5.
  - Is not meeting all of its OTS regulatory capital requirements.
  - Has entered into a consent to merge agreement, a supervisory agreement, or cease and desist order during the preceding two-year period, or is subject to a formal enforcement proceeding.
  - OTS determines is in troubled condition and has so notified the association in writing. Additionally, OTS may restrict or prohibit transactions with affiliates when the thrift falls into one of the under-capitalized categories as defined in Part 565 (Prompt Corrective Action).

If notified in writing by OTS, a thrift must provide 30-days advance written notice prior to entering into any affiliate transaction. The notice should contain a full description of the proposed transaction. If OTS raises no objections during the 30-day period, the association or its subsidiaries may proceed with the transaction.

### TRANSACTIONS WITH INSIDERS

In addition to the affiliate transaction restrictions, you must verify a thrift's compliance with standards for extensions of credit to insiders. Section 563.43 incorporates by reference application of the FRB's Regulation O (12 CFR Part 215) to federal savings associations, its subsidiaries and insiders (directors, executive officers, principal shareholders and related interests). Specifically, §563.43 applies the restrictions of 12 CFR Part 215, Subparts A and B (with the exception of 215.13), to savings associations and their subsidiaries and insiders in the same manner and to the same extent as if the association were a bank and a member bank of the Federal Reserve System.

Regulation O generally defines an extension of credit as making or renewing any loan, granting a line of credit or extending credit in any manner. An extension of credit, as defined at §215.3, includes the following transactions:

- A purchase under repurchase agreement of securities, other assets, or obligations.
- An advance by means of an overdraft, cash item, or otherwise.
- Issuance of a *standby letter of credit* (or other similar arrangement regardless of name or description) or an ineligible acceptance, as these terms are defined in §208.8(d).
- An acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which an insider may be liable as maker, drawer, endorser, guarantor, or surety.
- An increase of an existing indebtedness, but not if the association advances additional funds for its own protection for any of the following:

- Accrued interest.
- Taxes, insurance, or other expenses incidental to the existing indebtedness.
- An advance of unearned salary or other unearned compensation for a period in excess of 30 days.
- Any other similar transaction that results in a person becoming obligated to pay money (or its equivalent) to an association, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

A transaction becomes an extension of credit at the time the thrift enters into a binding commitment to make the extension of credit. OTS considers a participation without recourse an extension of credit by the participating association, not by the originating bank or association.

Section 215.3 excludes certain transactions from the definition of an extension of credit. An extension of credit does not include any of the following transactions:

- An advance against accrued salary or other accrued compensation, or an advance for the payment of authorized travel or other expenses incurred or to be incurred on behalf of the association.
- A receipt by an association of a check deposited in or delivered to the association in the usual course of business unless it results in the carrying of a cash item for or the granting of an overdraft (other than an inadvertent overdraft in a limited amount that is promptly repaid, as described in §215.4(e)).
- An acquisition of a note, draft, bill of exchange, or other evidence of indebtedness through any of the following means:
  - A merger or consolidation of or a similar transaction in which an association acquires assets and assumes liabilities of

another association or similar organization.

- Foreclosure on collateral or similar proceeding for the protection of the association. The association, however, must not hold such indebtedness for more than three years from the date of the acquisition, unless OTS grants an extension for good cause.
- *An endorsement or guarantee for the protection of an association* of any loan or other asset the association previously acquired in good faith, or any indebtedness to an association for the purpose of protecting the association against loss or of giving financial assistance to it.
- *Indebtedness of \$15,000 or less* resulting from any general arrangement in which an association acquires charge or time credit accounts or makes payments to or on behalf of participants in a credit card plan, check credit plan, or similar open-ended credit plan, provided that both of the following conditions apply:
  - The indebtedness does not involve prior individual clearance or the association's approval other than to determine authority to participate in the arrangement and comply with any dollar limit under the arrangement.
  - The indebtedness is incurred under terms that are not more favorable than those offered to the general public.
- *Indebtedness of \$5,000 or less resulting from an existing or previously established, interest-bearing overdraft credit plan.*
- A discount of promissory notes, bills of exchange, conditional sales contracts, or other similar paper, without recourse.
- Non-interest bearing deposits to the credit of an association are not considered loans, advances, or extensions of credit to the association of de-

posit; nor is the giving of immediate credit to an association upon uncollected items received in the ordinary course of business considered a loan, advance, or extension of credit to the depositing association.

### General Requirements

Extensions of credit by a thrift or its subsidiaries to its insiders not specifically excluded by §215.3 are subject to the general prohibitions of Regulation O. Beyond direct extensions of credit to insiders, an extension of credit is made to an insider if the insider uses the proceeds of the extension of credit for tangible economic benefit or the insider receives the proceeds indirectly. There is an exception to the economic benefit rule if both of the following criteria are met:

- The association extends the credit on terms prevailing at the time for comparable transactions with non-insiders (that would satisfy the standards set forth in §215.4(a)) and that do not involve more than the normal risk of repayment).
- The borrower uses the proceeds of the extension of credit in a bona fide transaction to acquire property, goods, or services from the insider.

Regulation O generally requires that most extensions of credit to insiders, or extensions of credit for the tangible economic benefit of insiders meet the following criteria:

- Advance approval by a majority of the disinterested board of directors of the association.
- No preferential terms, does not involve more than the normal risk of repayment, and does not present other unfavorable features.
- Does not exceed aggregate individual and overall lending limits.

In addition, Regulation O imposes additional restrictions on extensions of credit to executive

officers, and various reporting and recordkeeping requirements.

The flow chart in Table 2, Insider Lending Restrictions Guidelines, presents insider lending transactions in a step-by-step manner consistent with the format outlined below. As we previously stated, you can use the Affiliate Transactions checklist (see Appendix A) to review insider lending transactions as well as transactions with affiliates.

### Insiders

The Part 215 lending restrictions apply to executive officers, directors, and principal shareholders of the thrift and its affiliates. Insiders also include related interests of these executive officers, directors, and principal shareholders. Part 215 defines these terms which we summarize below.

*It is important to note that Part 215 defines affiliate differently than §§563.41 and 563.42 as discussed earlier in this section under transactions with affiliates. Section 215.2(a) defines affiliate to include only the thrift's holding company, and any other subsidiary of that holding company. Similarly, §215.2(c) defines "control" by a company or a person separately.*

#### *Executive Officer (Section 215.2(e))*

Regulation O defines an executive officer as a person who participates or has the authority to participate in the major policymaking functions of the institution or its affiliate regardless of title. For example, the term executive officer does not include a manager or assistant manager of a branch of an association unless that individual participates, or the association authorizes that individual to participate, in major policymaking functions. Regulation O presumes individuals with the following titles are executive officers:

- Chairman of the Board
- President
- Every Vice President
- Cashier

- Secretary
- Treasurer.

Regulation O does not generally consider directors, other than the Chairman of the Board, to be executive officers unless they serve in dual capacities as both a director and an executive officer.

In some cases, the thrift may exclude individuals from the definition of an executive officer. The thrift can make the exclusion by name or by title in a list of individuals excluded from participating in such functions. The thrift can also make the exclusion by not including the officer in a list of persons authorized (by name or title) to participate.

Thrifts may exclude individuals presumed to be executive officers from the definition of executive officer if the following circumstances exist:

- A resolution of the board of directors or the bylaws of the institution or affiliate, excludes the officer from participating in policy-making functions of the association.
- The officer does not actually participate in policy-making functions of the association.

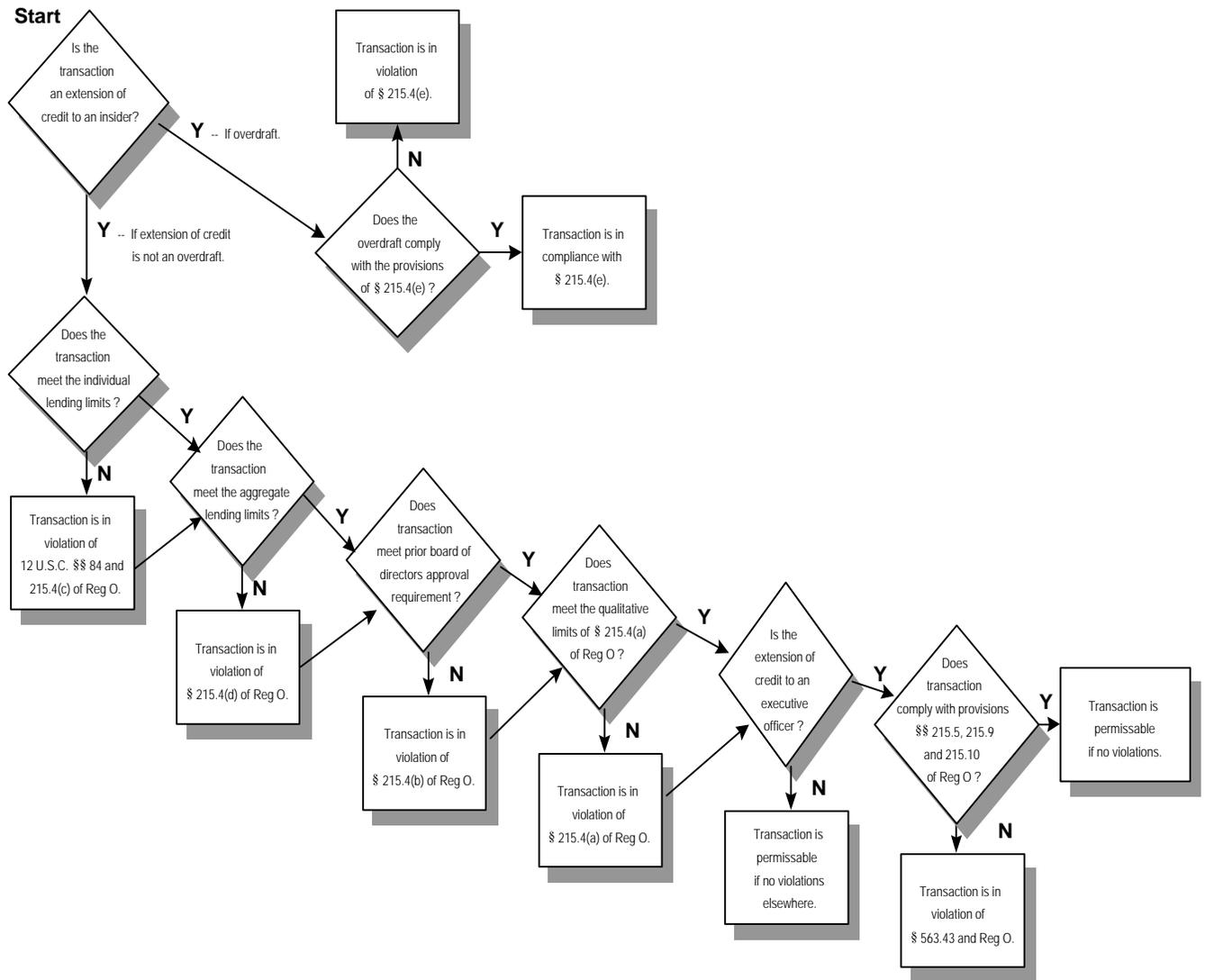
Additionally, executive officers of an affiliate of an association are not subject to §215.4 (General Prohibitions), §215.6 (Prohibition on knowingly receiving extensions of credit), and §215.8 (Records) if all of the following criteria are met:

- A resolution of the board of directors or the bylaws of the association, excludes the officer from participation in major policy-making functions of the association, and the executive officer does actually participate in such functions.
- The affiliate does not control the association.
- As determined annually, the assets of the affiliate do not constitute more than 10 percent of the consolidated assets of the company that:
  - controls the association; and

— is not controlled by any other company.

- The officer is not otherwise subject to §§ 215.4, 215.6, and 215.8.

**Table 2**  
**Insider Lending Restrictions**



*Director (§215.2(d))*

Regulation O defines a director to include any person who the association designates as a director, or who performs duties as a director of the association regardless of the amount of compensation. The term director includes trustees. The term does not include advisory directors, if they meet all of the following conditions:

- The shareholders do not elect them.
- They are not authorized to vote on matters before the board of directors.
- They provide solely general policy advice to the board of directors.

Regulation O provides an exception for extensions of credit to a director of an affiliate of an association. Unless otherwise subject by virtue of some other defining factor, (for example, the individual also serves as an executive officer of the association) directors of an affiliate are not subject to §215.4 (General prohibitions), §215.6 (Prohibition on knowingly receiving extensions of credit), and §215.8 (Records) if all of the following criteria are met:

- A resolution of the board of directors or the bylaws of the association excludes the director of the affiliate from participation in major policy-making functions of the association, and the director does not actually participate in such functions.
- The affiliate does not control the savings association.
- As determined annually, the assets of the affiliate do not constitute more than 10 percent of the consolidated assets of the company that:
  - controls the association; and
  - is not controlled by any other company.

*Principal Shareholder (§215.2(m))*

Regulation O defines a principal shareholder to mean a person (other than an insured association) that directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote more than 10 percent of any class of voting securities of an association or affiliate. The institution should consider shares that a member of an individual's immediate family (as defined at 215.2(g)) owns or controls as held by the individual.

*A principal shareholder does not include any company of which the association is a subsidiary. For example, principal shareholder excludes parent thrift holding companies.*

*Related Interests (§215.2(n))*

Regulation O defines a related interest to include any company that an insider controls. It also includes a political or campaign committee that an insider controls, or the funds or services of a political or campaign committee that benefit that insider.

**Restrictions on Extensions of Credit**

Section 215.4 of Regulation O contains basically four restrictions on extensions of credit with insiders:

- Lending limits.
- Prior approval requirements.
- Qualitative factors.
- Overdraft provisions.

*Lending Limits (§§215.4(c) and 215.4(d))*

Regulation O imposes both an aggregate and an individual lending limit on extensions of credit to insiders.

Aggregate Lending Limit — General Limit

An association may not extend credit to any of its insiders or insiders of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit by the association to such insiders, exceeds the association's unimpaired

capital and unimpaired surplus. In other words, the aggregate amount of all transactions with insiders may not exceed 100 percent of the institution's unimpaired capital and surplus.

#### Aggregate Lending Limit — Small Institutions

Institutions with less than \$100 million in deposits may make extensions of credit to insiders up to 200 percent of unimpaired capital and unimpaired surplus if all of the following circumstances exist:

- The board of directors determines by an annual resolution that a higher limit is consistent with safe and sound banking practices in light of the institution's experience in lending to its insiders and is necessary to attract or retain directors, or to prevent restricting the availability of credit in small communities.
- The board resolution discloses the facts and reasons for the board's findings noted above, including the amount of insider extensions of credit as a percentage of unimpaired capital and unimpaired surplus as of the date of the board resolution.
- The institution meets or exceeds all applicable capital requirements.
- The institution received a satisfactory composite CAMELS rating in its most recent report of examination.

If the institution subsequently fails to meet fully phased-in capital requirements or does not maintain a satisfactory composite rating, it cannot extend any additional credit (including a renewal of an existing extension of credit) to any insider of the association or its affiliates unless it is within the general aggregate lending limit.

#### Exceptions to the Aggregate Lending Limit

The aggregate lending limits do not apply to extensions of credit that meet the following criteria:

- Secured by a perfected security interest in bonds, notes, certificates of indebtedness, or Treasury bills of the United States or in other

such obligations fully guaranteed as to principal and interest by the United States.

- Extended to or secured by unconditional take-out commitments or guarantees of any department, agency, bureau, board, commission or establishment of the United States or any corporation wholly owned directly or indirectly by the United States.
- Secured by a perfected interest in a segregated deposit account in the lending savings association.
- Resulted from the discount of negotiable or nonnegotiable installment consumer paper acquired from an insider that carries a full or partial recourse endorsement or guarantee by the insider, provided that it meets all of the following criteria:
  - The financial condition of each maker of such consumer paper is reasonably documented in the thrift's files or known to its officers.
  - An officer of the thrift designated for that purpose by the board of directors of the thrift certifies in writing that the institution is relying primarily upon the responsibility of each maker for payment of the obligation and not upon any endorsement or guarantee by the insider.
  - The maker of the instrument is not an insider.

#### Individual Lending Limit

An association may not extend credit to any of its insiders or insiders of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit by the association to that person and to all related interests of that person, exceeds its lending limits as described at §560.93. This limitation does not apply to an extension of credit by an association to its affiliates, instead, sections §§563.41 and 563.42 govern these transactions.

The LTOB rule limits the total of all loans and extensions of credit by a savings association to one borrower, outstanding at one time, to 15 percent of the institution's unimpaired capital and surplus. An association may extend an additional 10 percent of unimpaired capital and surplus to one borrower if the additional amount comprises only loans and extensions of credit that are fully secured by readily marketable collateral.

The National Banking Act (12 USC §84(c)(1)-(10)) provides a list of 10 exceptions to the percentage ceilings for certain secured extensions of credit. The additional exceptions to thrift LTOB limitations contained in §5(u) of HOLA, are not available for extensions of credit to thrift insiders and related interests.

#### *Prior Board of Director Approval Requirement (§215.4(b))*

When the amount of an extension of credit exceeds certain thresholds, Regulation O requires prior board approval. In obtaining prior approval, the following actions must occur:

- A majority of the board of directors of the association approves the extension of credit in advance.
- The interested party abstains from participating directly or indirectly in the voting.

Prior approval, as described above, is not necessary for extensions of credit up to the lesser of \$25,000 or five percent of the association's unimpaired capital and unimpaired surplus. However, prior approval is always necessary for extensions of credit over \$500,000. In determining compliance with these thresholds, the institution must aggregate all extensions of credit to that person and to all related interests of that person.

Regulation O does not require board approval for any extension of credit the association makes pursuant to a line of credit the board of directors approved during the preceding 14 months.

#### *Qualitative Treatment (§215.4(a))*

An association may not extend credit to any of its insiders or insiders of its affiliates unless the association makes the extension of credit on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable transactions the association makes with other persons that are not insiders or otherwise employed by the association. The association must also follow its standard credit underwriting procedures, and cannot use less stringent underwriting procedures. Regulation O also requires that the extension of credit not involve more than the normal risk of repayment or present other unfavorable features.

This requirement does not, however, prohibit a thrift from making a "preferential" extension of credit to an insider if the thrift makes the extension of credit pursuant to an employee benefit or compensation program that is widely available to employees of the thrift and based on terms that are no more favorable than those offered to other employees. In addition, the benefit program cannot give preference to any insider over other employees.

#### *Overdrafts (§215.4(e))*

An association may not pay an overdraft on an account of one of its executive officers or directors, or an executive officer or director of its affiliates, unless the payment of funds meets one of the following criteria:

- Inadvertent overdraft(s), less than \$1,000 in the aggregate, overdrawn for 5 business days or less and subject to the same fee charged to other customers (unless subject to a widely available benefit plan for all employees).
- Paid in accordance with a written, preauthorized, interest-bearing extension of credit plan that specifies a method of repayment.
- Funded by a written, preauthorized transfer of funds from another account of the account holder at the association.

**Additional Restrictions on Extensions of Credit to Executive Officers**

Additional restrictions apply to extensions of credit to the thrift's executive officers. Thrifts may extend credit to an executive officer in any amount, subject to compliance with LTOB limitations, if the extension of credit is one of the following types:

- Finances the education of the executive officer's children.
- Finances or refinances the purchase, construction, maintenance, or improvement of a residence of the executive officer, provided two conditions occur:
  - A first lien on the residence secures the extension of credit and the executive officer owns the residence (or expects to own the residence).
  - In the case of refinancing, the refinance amount includes only the amount used to repay the original extension of credit, together with the closing costs of the refinancing, and any additional amount used to finance the purchase, construction, maintenance, or improvement of a residence.

*Note:* Extensions of credit on vacation or second homes owned or expected to be owned by the executive officer also qualify for this category of residential loan, but only one loan may be attributed to this category of loans. (Institutions must attribute all extensions of credit for other purposes, even if secured by a residence, to the "other purpose" category under 12 CFR §215.5(c)(4). The total outstanding amount of the other purpose category is subject to the dollar limits set forth below.)

- Secured by a perfected security interest in bonds, notes, certificates of indebtedness, or Treasury bills of the United States, or in other such obligations fully guaranteed as to principal and interest by the United States.

- Secured by unconditional takeout commitments or guarantees of any department, agency, bureau, board, commission or establishment of the United States or any corporation wholly owned directly or indirectly by the United States.
- Secured by a perfected interest in a segregated deposit account in the lending savings association.

Section 215.5(c)(4) limits the aggregate loan amount for all other extensions of credit to the greater of 2.5 percent of unimpaired capital and unimpaired surplus or \$25,000, but in no event more than \$100,000. In addition, §215.5(c)(4) limits to these same amounts, extensions of credit to a partnership in which one or more of the thrift's executive officers are partners and, either individually or together, constitute a majority interest, regardless of the purpose of the extension of credit or the type of collateral. For purposes of this limitation, the total amount of the extension of credit to a partnership is attributed to each officer of the thrift, individually, who is also a member of the partnership.

Any extension of credit to an executive officer must meet the following requirements:

- Reported promptly to the institution's board of directors.
- Comply with the terms and creditworthiness standards of §215.4(a) (i.e., not on preferential terms or involve more than the normal risk of repayment or other unfavorable features).
- Preceded by the submission of a detailed current financial statement of the borrower.
- Made subject to a written condition that the extension of credit will, at the option of the thrift, become due and payable at any time the officer becomes indebted to any other bank(s) or thrift(s) in an aggregate amount greater than the permissible ceiling for a category of borrowings cited above (as outlined in §215.5(c)).

**Miscellaneous Standards (§§215.6, 215.8, 215.9, 215.10, 215.11, and 215.12)**

These sections and recordkeeping standards in Part 215 deal primarily with the reporting requirements for various transactions with insiders. See Appendix B for a table of such requirements. Also, §215.6 prohibits insiders from knowingly violating applicable restrictions on extensions of credit to insiders and related interests.

**Provisions Governing Indebtedness to Correspondent Banks**

You should also determine whether a thrift complies with the provisions that generally prohibit preferential extensions of credit to insiders of correspondent banks and imposes certain recordkeeping requirements. (See Appendix B.)

**REFERENCES****United States Code (12 USC)***National Banking Act*

§84 (c) Lending Limits Exceptions

*Federal Reserve Act*

§371c Banking Affiliates (23A)  
 §371c- 1 Restrictions on Transactions with Affiliates (23B)  
 §375a Loans to Executive Officers (22(g))  
 §375b Prohibitions on Insider Loans (22(h))

*Home Owners' Loan Act*

§1467a Regulation of Holding Companies  
 §1468 Transactions with Affiliates, Insider Loans

*Bank Holding Company Act*

§1972(2)(H) Correspondent Accounts Definitions

**United States Code (15 USCA)***Investment Company Act*

80a-2(a)(20) Investment Adviser

**Code of Federal Regulations (12 CFR)***OTS Regulations*

§563.41 Loans and Other Transactions with Affiliates and Subsidiaries  
 §563.42 Additional Standards Applicable to Transactions with Affiliates and Subsidiaries  
 §563.43 Loans by Savings Associations to Their Executive Officers, Directors and Principal Shareholders  
 §563.200 Conflicts of Interest  
 §563.201 Corporate Opportunity  
 §574.4 Control  
 §584.2-2 Permissible Bank Holding Company Activities

*Federal Reserve Board Regulations*

Part 215 Regulation O (Insider Loans)  
 §225.28 List of Permissible Nonbanking Activities

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# Transactions with Affiliates and Insiders Program

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## Examination Objectives

Determine if transactions with affiliates and insiders are in regulatory compliance and not detrimental to the safety and soundness of the thrift.

Evaluate the extent and degree of influence of affiliations on the savings association.

## Examination Procedures

Wkp.Ref.

### Level I

1. Review examination scoping materials related to transactions with affiliates and insiders. If other regulator(s) perform the review of scoping materials, obtain a written or verbal summary of the review(s) of items concerning this program. Refer to the examiner in charge (EIC).

Scoping materials might include:

- The prior examination report.
- Prior exception sheets and work papers.
- Review of internal/independent audit reports, supervisory analysis, correspondence, the business plan, minutes of the meetings of the board of directors, PERK information, etc.

- 
2. Evaluate the savings association's policies and procedures for transactions with affiliates and insiders by reviewing policy statements, procedure manuals, board and committee minutes, and other pertinent documents.

- 
3. Obtain and review the Management Questionnaire. Based on the review of minutes and any additional interviews with management, determine the completeness and accuracy of the answers to this questionnaire.
- 

**Exam Date:** \_\_\_\_\_  
**Prepared By:** \_\_\_\_\_  
**Reviewed By:** \_\_\_\_\_  
**Docket #:** \_\_\_\_\_

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## Transactions with Affiliates and Insiders Program

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**Wkp.Ref.**

4. Verify that transactions with affiliates and insiders are in compliance with applicable regulations:
- §563.41
  - §563.42
  - §563.43 (which incorporates by reference the FRB's Regulation O at Part 215).

*Note:* Appendix A, Transactions with Affiliates Checklist, provides step-by-step instructions. Appendix B, Summary of Regulation Reporting/Recordkeeping Requirements is also a useful tool to determine regulatory compliance.

- 
5. Evaluate the association's documentation and recordkeeping to establish compliance with minimum standards.

- 
6. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

### Level II

- 
7. Evaluate the extent and degree of influence of outside affiliations on the savings association.

- 
8. From the review of information thus far, determine which transactions, if any, you should review for evidence of self-dealing or conflicts of interest or other safety and soundness concerns. Provide instructions to the examiners reviewing the appropriate areas.

- 
9. Ensure that the examination meets the *Objectives* of this Handbook Section. State your findings and conclusions and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

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**Exam Date:** \_\_\_\_\_  
**Prepared By:** \_\_\_\_\_  
**Reviewed By:** \_\_\_\_\_  
**Docket #:** \_\_\_\_\_

**Transactions with Affiliates and Insiders**

Association	City	State	Docket #
Affiliate/Insider			
Description of Transaction			

*Instructions:* Use this Checklist to review all types of transactions with affiliates and insiders. Use the Checklist in conjunction with the regulations since the checklist does not include all of the definitions, etc. Follow the Checklist until you reach a **STOP**.

Is the transaction between the savings association or its subsidiary and an insider? (12 C.F.R. Section 563.43)

- |  |   |
|--|---|
| <p><input type="checkbox"/> Yes</p> <p>Transaction may be subject to Section 563.43 (Sections 22(g) or 22(h) of the FRA)</p> <p>⇒ If the insider is a company, go to Part A</p> <p>⇒ If the insider is not a company, go to Part B</p> | <p><input type="checkbox"/> No</p> <p>Transaction may be subject to Sections 563.41 and 563.42 ⇒ Go to Part A</p> |
|--|---|

**PART A (563.41 and 563.42)**

*Note:* Sections 563.41 and 563.42 parallel Sections 23A and 23B of the Federal Reserve Act.

- Is the transaction between the association or its subsidiary and a company that conforms to the definition of an affiliate in Section 563.41(b)(1) and (2)?
 

<p><input type="checkbox"/> Yes</p> <p>Transaction is with an affiliate as defined in Section 563.41</p> <p>– If transaction is a loan ⇒ Go to Next Step</p> <p>– If transaction is not a loan ⇒ Go to Step 3</p>	<p><input type="checkbox"/> No</p> <p>Transaction is not subject to the affiliate restrictions in Sections 563.41 and 563.42</p> <p>⇒ Go to Part B (563.43)</p>
---	---
  
- Does the affiliate engage only in activities permissible for bank holding companies as outlined in 12 C.F.R. Section 584.2-2?
 

<p><input type="checkbox"/> Yes</p> <p>Transaction may be subject to Sections 563.41 and 563.42 ⇒ Go to Step 4</p>	<p><input type="checkbox"/> No</p> <p>Transaction is a violation of Section 563.41(a)(3)</p> <p>⇒ STOP</p>
--	--
  
- Does the transaction involve the purchase of, or investment in, securities issued by an affiliate that is not a subsidiary of the association?
 

<p><input type="checkbox"/> Yes</p> <p>Transaction is a violation of Section 563.41(a)(4)</p> <p>⇒ STOP</p>	<p><input type="checkbox"/> No</p> <p>Transaction may be subject to Sections 563.41 and 563.42 ⇒ Go to Next Step</p>
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- 
4. Is the transaction a "covered transaction" pursuant to Section 563.41(b)(7)?
- Yes  
Transaction is a covered transaction as defined in Section 563.41(b)(7) ⇨ Go to Next Step
- No  
Transaction is not subject to the affiliate restrictions in Section 563.41 ⇨ Go to Step 8
5. Is the transaction exempt pursuant to Section 563.41(d)?
- Yes  
Transaction must still be consistent with safe and sound banking practices ⇨ Go to Step 8
- No  
Transaction is subject to quantitative restrictions ⇨ Go to Next Step
6. Does the transaction meet the quantitative restrictions of Section 563.41(a)(1)?
- Yes  
Transaction meets the quantitative restrictions ⇨ Go to Next Step
- No  
Transaction is in violation of Section 563.41 ⇨ Go to Next Step
7. Does the transaction meet the qualitative restrictions of Sections 563.41(a)(5) and 563.41(c)?
- Yes  
Transaction meets the qualitative restrictions ⇨ Go to Next Step
- No  
Transaction is in violation of Section 563.41 ⇨ Go to Next Step
8. Is the transaction covered by Section 563.42(a)(2)?
- Yes  
Transaction is subject to the qualitative restrictions of Section 563.42 ⇨ Go to Next Step
- No  
Transaction is not subject to Section 563.42 ⇨ Go to Part B (Section 563.43)
9. Is the transaction prohibited by Section 563.42(b)?
- Yes  
Transaction is in violation of Section 563.42 ⇨ Go to Part B (Section 563.43)
- No  
Transaction is in compliance with Section 563.42 ⇨ Go to Next Step
10. Is the transaction on terms substantially the same as those offered to nonaffiliated companies?
- Yes  
Transaction is in compliance with the qualitative restrictions of Section 563.42 ⇨ Go to Part B (Section 563.43)
- No  
Transaction is in violation of the qualitative restrictions of Section 563.42 ⇨ Go to Part B (Section 563.43)

**PART B (563.43)**

*Note:* This part tracks the portions of 563.43 and Reg. O that are authorized by 22(h) of the FRA.

1. Is the transaction an extension of credit as defined by Section 215.3 of Reg. O?

Yes

Transaction may be subject to the restrictions of Section 563.43

- overdraft ⇨ Go to Step 13
- any other extension of credit
- ⇨ Go to Next Step

No

Transaction is not subject to the restrictions of Section 563.43 ⇨ STOP

2. Is the extension of credit with an insider? (Do not consider exclusions or special provisions)

Yes

Transaction must be reviewed under Section 22(h).

- executive officer ⇨ Go to Step 3
- related interest ⇨ Go to Step 4
- principal shareholder ⇨ Go to Step 6
- director ⇨ Go to Step 9

No

Transaction is not subject to the restrictions of Section 563.43 ⇨ STOP

*Note:* If the insider holds more than one position, follow directions for the first applicable step.

3. Is the individual excluded from the definition of an executive officer and was this exclusion appropriate? (Section 215.2(e))

Yes

Transaction is not subject to the restrictions of Section 563.43 ⇨ STOP

No

Transaction may be subject to the restrictions of Section 563.43 ⇨ Go to Step 9

4. Does an insider have control over a company as defined in Section 215.2(c)(1)?

Yes

Transaction may be subject to the restrictions of Section 563.43 ⇨ Go to Next Step

No

Transaction is not subject to the restrictions of Section 563.43 ⇨ STOP

5. Does this control relationship result in a rebuttable control determination?

Yes

The control determination may be rebutted  
⇨ Go to Step 7

No

Transaction is subject to the restrictions of Section 563.43  
⇨ Go to Step 9

6. Does a person or company meet the requirements of a principal shareholder? (Parent holding companies are excluded from the definition of principal shareholder.)

Yes

Individual/company is an insider  
⇨ Go to Step 9

No

Transaction is not subject to the restrictions of Section 563.43 ⇨ STOP

7. Has the individual rebutted the presumption?

Yes

Individual contends he is not in a control position ⇨ Go to Next Step

No

Individual is considered an insider ⇨ Go to Step 9

8. Was the rebuttal accepted by the OTS?

Yes

Individual is not considered an insider ⇨ STOP

No

Individual is considered an insider ⇨ Go to Step 9

9. Does the transaction meet the individual lending limitations set forth at Section 215.4(c)?

Yes

Transaction meets individual lending limitation ⇨ Go to Next Step

No

Transaction is in violation of Section 563.43 ⇨ Go to Next Step

*Note:* Transactions with related interests should be aggregated with other extensions of credit to its insider.

10. Does the transaction meet the aggregate lending limitations set forth at Section 215.4(d)?

Yes

Aggregate limitations are met ⇨ Go to Next Step

No

Transaction is a violation of Section 563.43 ⇨ Go to Step 11

11. Did the transaction meet the board of directors prior approval requirements at Section 215.4(b)? (if unnecessary, check yes)

Yes

Transaction meets prior approval requirements ⇨ Go to Next Step

No

Transaction is a violation of Section 563.43 ⇨ Go to Next Step

12. Does the transaction meet the qualitative requirements of Section 215.4(a)?

Yes

Transaction meets qualitative requirements  
– executive officer ⇨ Go to Part C  
– director, principal shareholder or related interest ⇨ STOP

No

Transaction is a violation of Section 563.43  
– executive officer ⇨ Go to Part C  
– director, principal shareholder or related interest ⇨ STOP

13. Is the overdraft to a principal shareholder, or related interest of an insider?

Yes

Transaction is permissible ⇨ Go to Next Step

No

Transaction may be subject to Section 215.4(e) ⇨ Go to Next Step

14. Is the overdraft to an executive officer?

Yes

Transaction is subject to Section 215.4(e) ⇨ Go to Next Step

No

Transaction may be subject to Section 215.4(e) ⇨ Go to Step 16

15. Has the association excluded the individual from being considered an executive officer for purposes of Reg. O and was the exclusion appropriate? (Section 215.2(e))

Yes

Transaction is permissible ⇨ STOP

No

Transaction is subject to Section 215.4(e)  
⇨ Go to Step 18

16. Is the overdraft to a director?

Yes

Transaction is subject to Section 215.4(e)  
⇨ Go to Next Step

No

Transaction is permissible  
⇨ STOP

17. Has the association excluded the individual from being considered a director of an affiliate for purposes of Reg. O and was the exclusion appropriate? (Section 215.2(d))

Yes

Transaction is permissible  
⇨ STOP

No

Transaction is subject to Section 215.4(e)  
⇨ Go to Next Step

18. Does the overdraft meet the limitations of Section 215.4(e)?

Yes

Transaction is in compliance ⇨ STOP

No

Transaction is in violation of Section 563.43 ⇨ STOP

### PART C (563.43)

*Note:* This part tracks the portions of 563.43 and Reg. O that are authorized by section 22(g) of the FRA (12 C.F.R. Sections 215.5, 215.9 and 215.10).

1. Is the extension of credit to an executive officer of the savings association?

Yes

Transaction is covered by Section 22(g)  
⇨ Go to Next Step

No

Transaction is not subject to Section 22(g)  
⇨ STOP

2. Has the association extended credit to the executive officer for the purpose of financing the education of the executive officer's children?

Yes

Transaction is in compliance with Section 215.5(c)  
⇨ Go to Step 7

No

Transaction may be subject to the limitations of Section 215.5(c)(4) ⇨ Go to Next Step

3. Has the association extended credit to the executive officer to finance the purchase, construction, maintenance, or improvement of a residence of the executive officer *and* the extension of credit is secured by a first lien on the residence *and* the residence is owned (or expected to be owned after the extension of credit) by the executive officer?

Yes

Transaction is in compliance with Section 215.5(c) ⇨ Go to Step 7

No

Transaction is subject to the limitations of Section 215.5(c)(4) ⇨ Go to Next Step

4. Is the extension of credit secured as described in Section 215.4(d)(3)(i)(A) through (d)(3)(i)(C)?

Yes

Transaction is in compliance with 215.5(c)

⇨ Go to Step 7

No

Transaction is subject to the limitations of Section

215.5(c)(4) ⇨ Go to Next Step

5. Does the extension of credit, when added to all other extensions of credit to the executive officer (except those described in questions 2, 3 and 4) exceed the greater of 2.5% of the thrift's capital and unimpaired surplus or \$25,000?

Yes

Transaction is in violation of Section 215.5(c)(4)

⇨ Go to Step 7

No

Transaction may be in compliance with Section 215.5(c)(4)

⇨ Go to Next Step

6. Does the extension of credit, when added to all other extensions of credit to the executive officer (except those described in questions 2, 3 and 4) exceed \$100,000?

Yes

Transaction is in violation of Section 215.5(c)(3)

⇨ Go to Next Step 215.5(c)(4)

No

Transaction is in compliance with Section 215.5(c)(4)

⇨ Go to Next Step

Note: You should aggregate together the total amount of all extensions of credit:

- To partnerships in which one or more of the thrift's executive officers are partners, and either individually or together hold a majority interest.
- To the individual executive officers.

7. Has the executive officer met the reporting requirements and limitations of Sections 215.5(d)?

Yes

Transaction is in compliance with Sections 215.5(d)

⇨ STOP

No

Transaction is in violation of Section 215.5(d)

⇨ STOP

Exemptions/Exclusions/Special Provisions

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Violations Noted

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**Regulation O Summary of Reporting/Recordkeeping Requirements**12 C.F.R.  
SectionRequirement

215.8

**Records of Institution**

The thrift must maintain records that identify its insiders through an annual survey. Any recordkeeping method the institution adopts must include extensions of credit to insiders of the thrift's affiliates. The thrift can identify insiders of affiliates through an annual survey or by borrower inquiry method at the time the thrift makes an extension of credit. OTS may deem alternative methods acceptable.

The thrift must also specify the amount and terms of each extension of credit made to these persons and their related interests. Records must be sufficient to demonstrate compliance with applicable lending restrictions.

215.9

**Reports by Executive Officers**

Executive officers must provide a written report to the thrift's board of directors within 10 days of becoming indebted to any other bank or thrift if the aggregate amount of the indebtedness exceeds \$100,000 (or the greater of 2.5 percent of the thrift's capital and surplus or \$25,000). The report must state the lender's name, the date and the amount, security and purpose of each extension of credit.

215.10

**Reports on Credit to Executive Officers**

Thrifts must report in Schedule SI of its quarterly TFR all extensions of credit to its executive officers.

215.11

**Disclosure of Credit to Executive Officers and Principal Shareholders**

Upon written request from the public, the thrift must make available a list of executive officers and principal shareholders and their related interests to whom the institution has an outstanding extension of credit that when aggregated with all other outstanding extensions of credit to that individual and their related interests equals or exceeds 5 percent of the thrift's capital and surplus or \$500,000, whichever is less. The thrift does not have to disclose extensions of credit to any one person and their related interests that does not exceed \$25,000. The thrift also need not disclose specific amounts of individual extensions of credit.

**215.12 Reporting Requirement for Credit Secured by Certain Bank Stock**

Executive officers or directors of institutions whose shares are not publicly traded must annually report to the board of directors any outstanding credit secured by shares of the thrift.

**215.22 Reports by Executive Officers and Principal Shareholders or Their Related Interests**

On or before January 31 of each year, executive officers and principal shareholders must report to the board of directors outstanding indebtedness to correspondent banks of the thrift. The thrift must notify executive officers and principal shareholders of this requirement, make available a list of the correspondent banks, and maintain the reports for three years. Thrifts may use FFIEC Form 004 (attachment to OTS TB 64-1c) or maintain the information in a similar format.

**215.23 Disclosure of Credit from Correspondent Banks to Executive Officers and Principal Shareholders**

Upon written request from the public, the thrift must make available the names of executive officers, principal shareholders and their related interests to whom a correspondent bank has outstanding extensions of credit to the individual and their related interests that equal or exceed 5 percent of capital and surplus or \$500,000, whichever is less. The thrift does not have to disclose extensions of credit to any one person and their related interests that does not exceed \$25,000. The thrift also need not disclose specific amounts of individual extensions of credit.