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 unreasonable 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

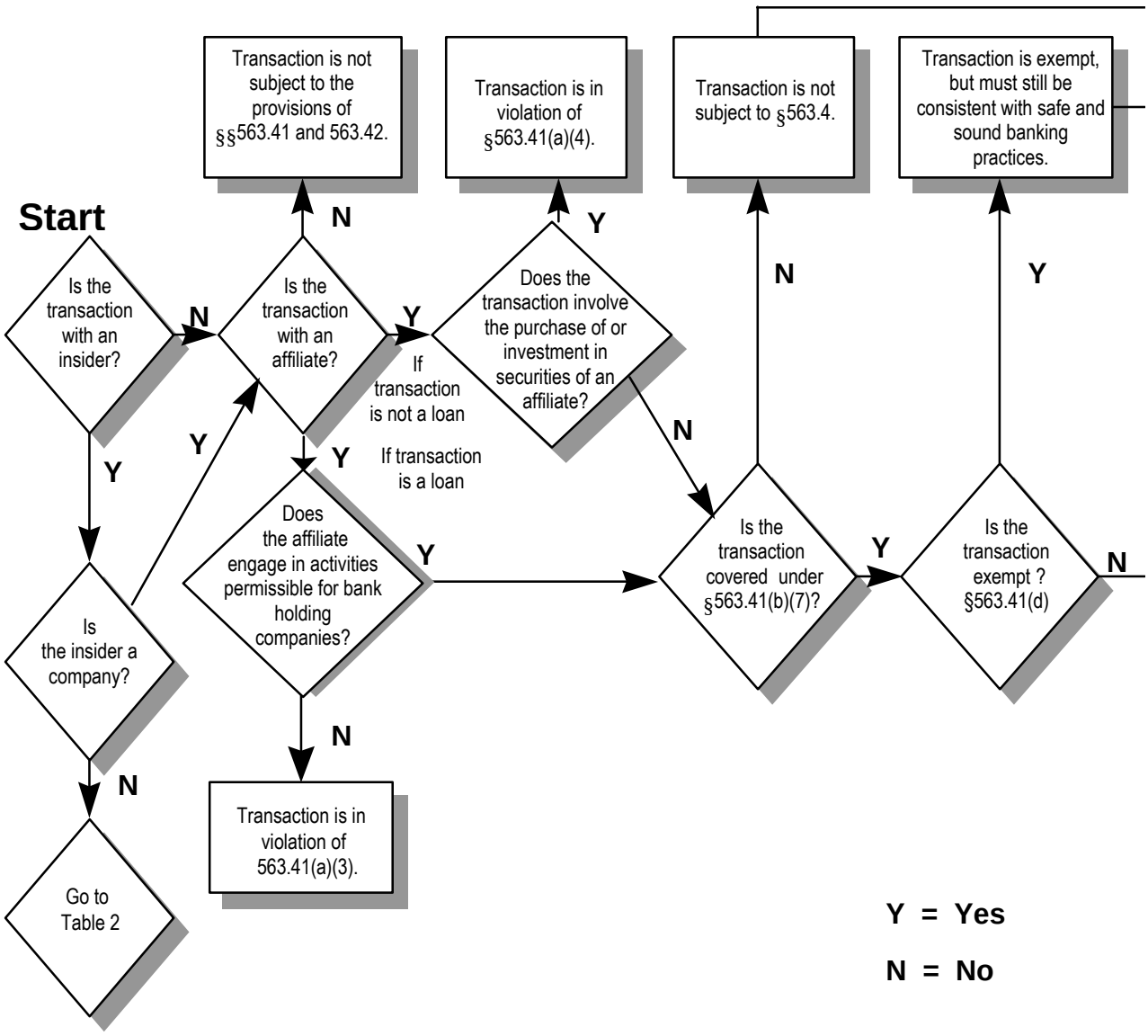
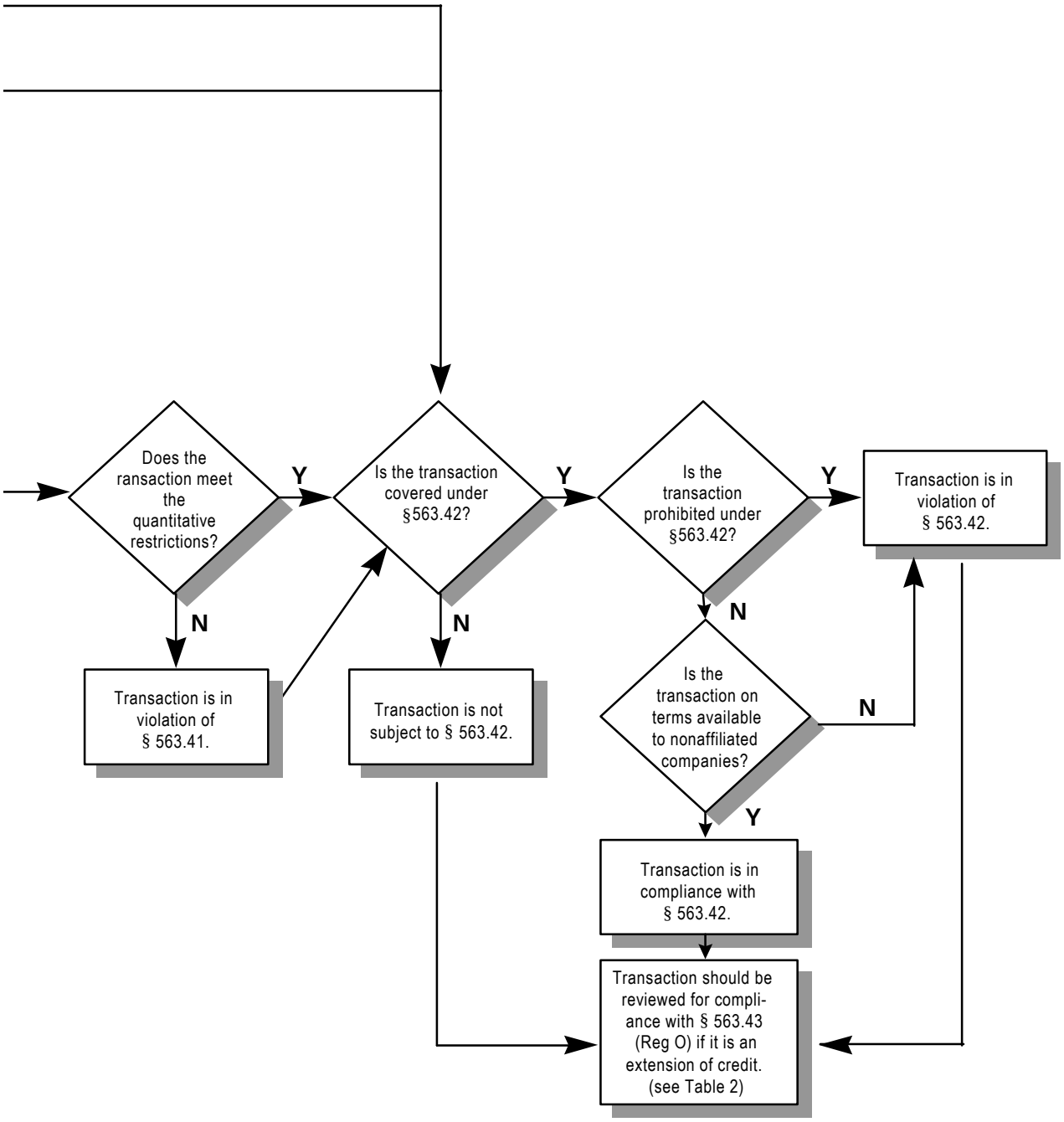


Table 1

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, identity 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 <u>all</u> 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 restrictions 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 purchase 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 fiduciary 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 over-

draft 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 deposit; 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.

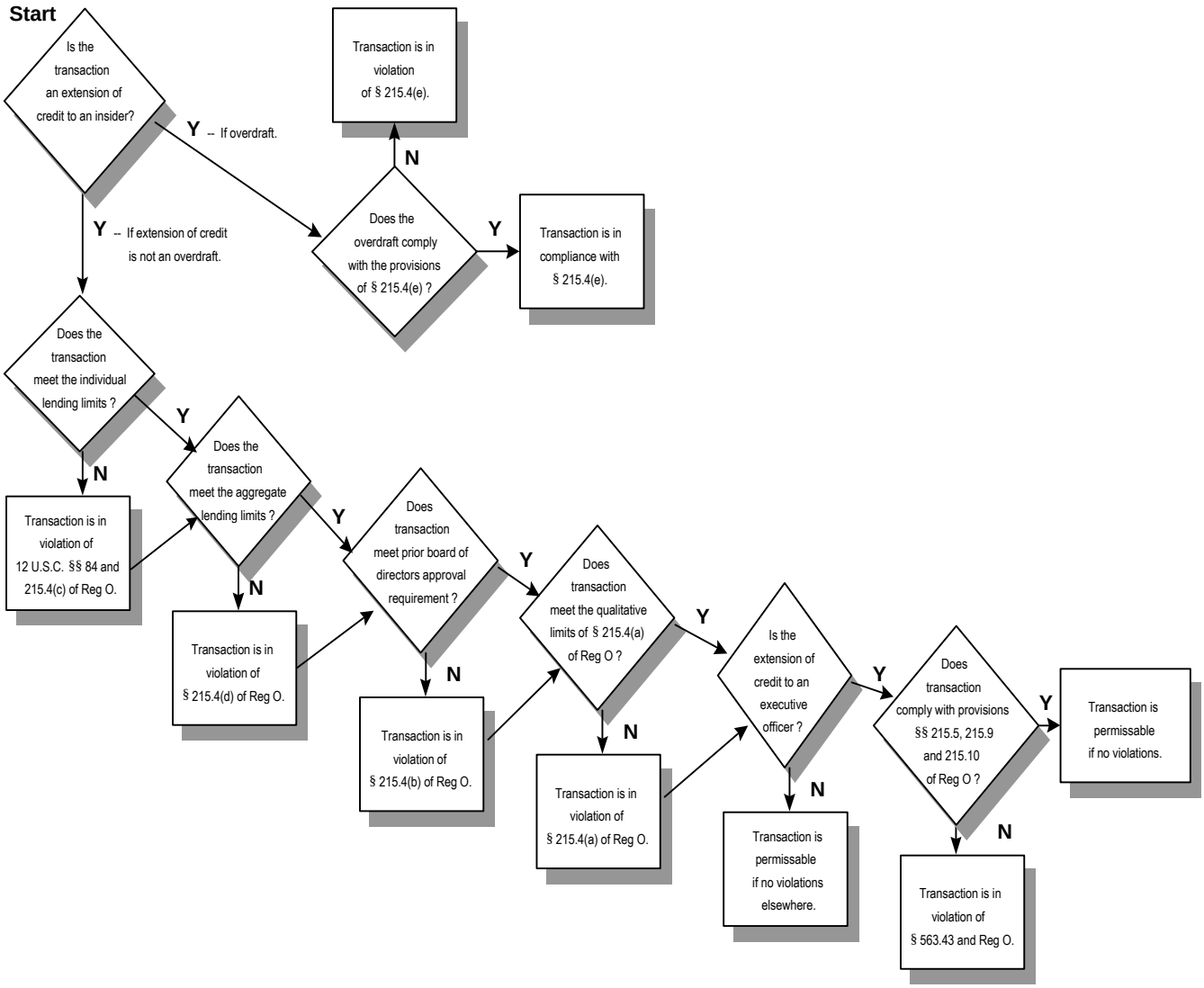
In some cases, the thrift may exclude individuals from the definition of an executive officer. The thrift can make the exclusion by name or by title in a list of individuals excluded from participating in such functions. The thrift can also make the exclusion by not including the officer in a list of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

Table 2
Insider Lending Restrictions



- 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.

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 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.
- 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 institu-

tion 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 higher 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 <u>one</u> 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 <u>each</u> 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 a 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