

**INTRODUCTION**

The examination of related organizations is essential in evaluating the overall safety and soundness of a savings association. Related organizations can significantly affect the operations and overall financial condition of their parent thrift. The purpose of the examination is to determine the extent to which the related organization poses a risk to the parent thrift. In identifying areas of risk, the regulator must fully understand the relationship between the parent thrift and its related organizations. This relationship will vary depending on, among other considerations, the amount of the parent thrift's investment, the organization's activities, the extent to which business is conducted through multiple "lower tier" entities, and restrictions imposed by regulation.

This Section provides the regulator with an overview of the types of related organizations that thrifts may establish, applicable regulations and restrictions, and issues of safety and soundness that are particular to the examination of related organizations. A discussion of the general approach to conducting examinations of related organizations is provided in the latter part of this Section along with examination procedures.

For purposes of this Section, the term "related organizations" refers to subsidiaries of thrifts and includes service corporations (their lower tier subsidiaries and joint ventures or limited partnerships), operating subsidiaries, and finance subsidiaries. *A thrift "affiliate," as defined under 12 CFR § 563.41, is not included in this definition of a related organization.* For example, under § 563.41, a savings and loan holding company is an affiliate of its subsidiary thrift and its related organizations. Transactions between an association (or its subsidiaries) and an affiliate are governed by 12 CFR §§ 563.41 and 563.42. Also, refer to the Holding Companies Regulatory Handbook, Section 400, Transactions with Affiliates.

Unless stated otherwise, this Section specifically refers to a federal thrift's authority to establish subsidiaries and to conduct activities through these

entities. To determine whether similar authority exists for state-chartered associations, the state laws and regulations must be consulted. Generally, a state savings association's authority to invest in and conduct activities through related organizations may not, under 12 CFR § 303.13, exceed that specifically permissible for a federal thrift unless prior FDIC approval is obtained. (Only state thrifts in compliance with their fully phased-in capital requirement are eligible to apply to the FDIC for such approval.)

All insured thrifts are required to notify the OTS (§ 563.37) and the FDIC (§ 303.13) at least 30 days prior to establishing or acquiring a subsidiary or conducting a new activity in an existing subsidiary. Unless specific application requirements apply, the OTS will accept a notification in the format filed with the FDIC. The regulator should determine whether the subsidiary was established and is operating as proposed and that related activities are limited to those described in the notification as approved by OTS order.

**TYPES OF RELATED ORGANIZATIONS**

There are basically three types of related organizations: service corporations, operating subsidiaries and finance subsidiaries. Each type of related organization is subject to a specific regulation. Service corporations and their subsidiaries are subject to 12 CFR § 545.74, operating subsidiaries are subject to § 545.81, and finance subsidiaries are subject to § 545.82. The following discussion provides greater detail concerning the regulatory requirements and restrictions that pertain to each type of related organization.

**Service Corporations**

Service corporations and their subsidiaries provide federal thrifts with several benefits, including investment in activities that the parent thrift may otherwise be prohibited from engaging in directly. (For federally chartered thrifts, such activities currently include securities brokerage and real estate

development.) Additionally, thrifts might invest in a service corporation in order to: share ownership interest with other associations; pool resources for providing specialized and costly services; conduct business outside of the state in which its home office is located; offer employee compensation structures that are different from those offered by the parent thrift; or insulate itself from potential legal liability of financial losses arising from the activity.

#### *Definitional Requirement*

To satisfy the definition of a service corporation set forth in the Home Owners' Loan Act (HOLA) at 12 USC § 1464(5)(c)(4)(B), a corporation must be organized under the laws of the state in which the federal thrift's home office is located and its entire capital stock is only available for purchase by that state's savings associations and federal thrifts with home offices in the state.

#### *Investment Limitations*

In order to prevent concentration of assets and to minimize risk, the HOLA limits the amount that a federal thrift may invest in a service corporation. Section 545.74(d) provides that an association may invest up to 3% of its assets in a service corporation. Any investment in excess of 2% must primarily serve community, inner-city, or community development purposes (as defined by the regulation). Under certain circumstances, a federal thrift that meets its applicable capital requirement may, subject to restrictions, make additional conforming loans to its subsidiaries. Section 545.74(d)(2) should be consulted for details regarding the specific requirements for such additional lending to subsidiaries.

To determine the parent thrift's investment in service corporations, include equity plus all loans, guarantees, or take-out commitments of such loans, to service corporations. (Refer to Handbook Section 230, Equity Investments, for a worksheet detailing the calculation for investments in service corporations.) Investments in the service corporation's "lower tier" subsidiaries should also be included. These subsidiaries are generally subject to the same regulatory and statutory requirements imposed on service corporations.

#### *Tiers of Service Corporations*

The OTS differentiates among the various "tiers" of service corporations. First tier entities are subsidiaries owned by the parent thrift directly and lower tier entities are those in which a first tier entity, or its subsidiaries, has an investment. While the first tier service corporation must be incorporated where its parent thrift's home office is located, a lower tier, either a "subsidiary" or "joint venture," may be incorporated elsewhere.

To qualify as a *subsidiary* under § 545.74(a)(4), an entity must be wholly owned or a joint venture in which a service corporation, directly or indirectly, owns, controls or holds (with power to vote) more than 25% of the capital stock, is a general partner, or is a limited partner and contributed more than 25% of the limited partnership's capital.

A *joint venture*, as defined at § 545.74(a)(3), is any joint undertaking by a service corporation or its wholly owned subsidiary with one or more persons or legal entities. Joint ventures may take the legal form of a joint tenancy, tenancy in common, or partnership. (Refer to the Glossary in this Handbook for the definitions of these terms.) As defined here, a joint venture also includes an investment in a corporation other than a wholly owned subsidiary.

#### *Permissible Activities*

Once established, service corporations and their subsidiaries may engage directly, or indirectly, in activities that may otherwise be prohibited for thrifts. These activities must be "preapproved" by regulation, as detailed in § 545.74(c), or specifically authorized by the OTS or the FDIC. In determining whether a service corporation's activities are permitted, the regulator should review the charter of the parent thrift and the service corporation. As noted above, restrictions on activities may vary depending on whether the parent thrift has a state or federal charter.

Thrift management should be able to demonstrate that the service corporation's activities are permitted. Investments in a subsidiary that engages in impermissible activities or exceed regulatory limits must be promptly disposed of or brought into

compliance within 90 days as set forth at § 545.74(e), unless the FDIC has approved such practices. In addition, § 545.74(b) authorizes the OTS to limit or prohibit a service corporation's activities for supervisory reasons. When an examination reveals that an activity is not conducted in a prudent manner or that proposed activities would present substantial risk to the parent thrift, the regulator should require that corrective action be taken.

The following discusses in greater detail the regulatory requirements for investing in and conducting activities through service corporations, including preapproved activities, activities requiring prior OTS or FDIC notification or approval, and service corporation reporting requirements.

#### *Preapproved Activities*

A parent federal thrift eligible for expedited treatment under 12 CFR § 516.3 is not required to file an application with OTS in order for its service corporation to engage in the "preapproved" activities listed under § 545.74(c)(1) to 545.74(c)(7). The preapproved status of these activities does not relieve the parent thrift of the requirement to file 30-day notifications with the FDIC and OTS prior to commencing a new activity through an existing subsidiary.

Thrifts that are ineligible for expedited treatment under § 516.3 must, regardless of whether an activity is preapproved for federal thrifts, file a service corporation application in accordance with § 516.1, and obtain OTS approval to make any new investment in a service corporation that engages in an activity that a federal thrift is prohibited from engaging in directly.

The preapproved activities listed in § 545.74(c) are divided into six general areas and include:

#### Loans

Preapproved loan activities include originating, investing in, selling, purchasing (including purchasing participations in), servicing, or otherwise dealing in loans (including brokerage or warehousing):

- secured by real estate;
- for repairing, equipping, or improving real estate;
- for business purposes that are insured or guaranteed by an agency of the United States;
- for education;
- that are consumer loans, including inventory and floor planning; and
- for commercial purposes.

*Note:* The combined commercial loan activities of the parent thrift and its subsidiaries may not exceed 10% of the parent thrift's total assets. Where a corporation is owned by more than one thrift, each parent thrift must include a portion of the subsidiary's commercial loans based on its proportionate ownership of the service corporation.

#### Services Primarily for Financial Institutions

These preapproved activities include:

- credit analysis, appraising, construction loan inspection, and abstracting;
- developing personnel benefit programs;
- conducting research, studies and surveys;
- managing data storage facilities for duplicate records;
- conducting certain advertising involving brokerage and other services;
- serving as an escrow agent;
- providing liquidity management, investment, advisory, and consulting services;
- providing clerical, accounting, or internal auditing services;
- establishing, owning, leasing, operating, or maintaining remote service units; and
- purchasing office supplies, furniture and equipment.

*Note:* The foregoing are not preapproved for customers other than financial institutions.

### Real Estate Services

Preapproved real estate services include:

- maintaining and managing real estate;
- managing a home owners association for rental projects;
- providing home ownership and financial counseling;
- providing relocation services;
- providing real estate brokerage for the parent thrift, service corporation, or a joint venture (but not for property owned by third parties);
- acquiring real estate for prompt development or subdivision, improvement, resale or leasing to others for improvement, or as manufactured home sites;
- acquiring improved real estate or manufactured homes to be held for rental or resale, remodeling, renovating, or demolishing and rebuilding for resale or rental; and
- acquiring, maintaining and managing real estate (improved or unimproved) to be used for offices and related facilities of a stockholder of the service corporation, or for offices and related facilities of the corporation. (To the extent that such activities are performed under a prudent program of property acquisition to meet the stockholder's present needs or reasonable future needs.)

*Note:* OTS approval of real estate activities is required if:

- the proposed activity would cause the outstanding aggregate book value of all investment real estate owned by a thrift and its service corporations to exceed its total capital (12 CFR § 567.5(c)); or
- the development, subdivision, and construction of improvements is not proposed to be completed within eleven years.

### Securities Brokerage Services

Preapproved securities brokerage activities are subject to numerous requirements and restrictions set forth under § 545.74(c). The scope of these activities is limited to acting as executing agency, providing investment advice, and engaging in riskless principal transactions. A “riskless principal transaction” occurs where a dealer, after receiving an order for a security, purchases the security from another firm for its own account and concurrently sells that security to the customer.

Securities dealing, market making, underwriting, and investment banking; all of which entail purchasing and holding securities for the dealer's account, are not preapproved. As is the case for any activity that is not preapproved, an application may be filed with the OTS for consideration.

*Note:* A detailed discussion of the regulatory restrictions and requirements applicable to these services is provided in Handbook Section 710, Nondeposit Investment Sales, and Thrift Bulletin (TB) 23-2, Interagency Statement on Retail Sales of Nondeposit Investment Products.

### Other Investments

Preapproved investments include:

- securities of corporations or partnerships authorized under Title IX of the Housing and Urban Development Act of 1968, 42 USC § 3931;
- a savings account of the parent thrift, provided that there is no special consideration given;
- certain investments in an interim federal thrift;
- certain tax-exempt bonds of state governments or political subdivisions thereof, and certain tax exempt obligations of public housing agencies;
- certain small business investment companies;
- interest-rate futures transactions subject to 12 CFR § 563.74;
- financial options trading subject to § 563.175; and

- other investments set forth under §§ 563.71 through .73 and § 545.76 and in 12 USC § 1464(c)(1)(C) through (F), (M) and (N).

#### Other Services

Preapproved activities referred to as “other services” include:

- preparing state and federal tax returns for individuals and nonprofit corporations;
- insurance brokerage or agency for liability, casualty, automobile, life, health, accident, or title insurance, but not private mortgage insurance;
- providing fiduciary services upon application to the OTS;
- issuing notes, bonds, debentures, or other obligations or securities;
- issuing and extending credit on credit cards and related operations;
- acquiring personal property for leasing;
- providing data processing services pursuant to 12 CFR § 545.138;
- issuing letters of credit; and
- purchase and sale of U.S. gold coins.

#### Activities “Reasonably Incident” to Preapproved List

*Reasonably incident* describes an activity that is necessary or convenient to the performance of a preapproved activity and is interpreted narrowly. An association must own a service corporation engaged in the underlying preapproved activity in order to invest in an activity that is reasonably incident. For example, a service corporation that is developing a housing subdivision might be preapproved to temporarily operate a water utility for homeowners until the project is completed. In determining whether activities are “reasonably incident” to preapproved activities, the regulator should consult with the OTS Chief Counsel’s Office.

#### *Other Reasonably Related Activities*

In order to invest in a service corporation that engages in an activity that is not preapproved, an association must file an application to obtain prior OTS approval. Additionally, each tier below the service corporation is limited to the same activities as the first tier unless specific approval is obtained for engaging in other business activities. Service corporations that are not wholly owned are similarly restricted by the regulation.

The OTS has approved applications to conduct the following types of reasonably related activities:

- underwriting mortgage life, mortgage disability, credit life, or credit disability insurance on borrowers or account holders of the parent thrift and its related organizations;
- reinsuring mortgage life, mortgage disability, credit life, or credit disability;
- acting as a collection agency for third parties;
- referring clients to mutual fund brokers;
- underwriting mutual funds;
- exchanging foreign currency;
- acting as a mutual fund administrator; and
- sponsoring, distributing and selling investment company shares.

Management must be able to demonstrate that it has obtained the necessary authority to engage in any activity that is not preapproved under § 545.74(c). The regulator should verify that the service corporation is conducting such activities in accordance with any approval conditions that may have been established in an effort to address potential legal and supervisory concerns.

#### *Service Corporation Reporting Requirements*

Reports filed with the OTS are a primary source of data for verifying whether the parent thrift and its service corporations comply with relevant activities restrictions and investment limitations. A parent thrift must maintain two sets of books for reporting its investment in service corporations and

their subsidiaries. One set is to be prepared in accordance with generally accepted accounting principles (GAAP), while the other must meet OTS reporting requirements set forth in the Thrift Financial Report (TFR) Instruction Manual.

#### GAAP Reporting Requirements

Generally, a thrift's investment in a related organization should follow GAAP. GAAP requires consolidated financial statements for multiple organizations. Under GAAP, investments in related organizations must be recorded under one of three accounting methods (i.e., consolidation, equity, or cost). The appropriate accounting method depends on the extent of ownership and the extent to which control can be demonstrated over the related organization.

A discussion of GAAP reporting methods is provided in Handbook Section 230, Equity Investments. Accounting guidance is also provided in Accounting Research Bulletin (ARB) No. 5, Accounting Principles Board Opinion (APBO) No. 18, and Statement of Financial Accounting Standards (SFAS) No. 94.

#### OTS Reporting Requirements

In reporting its investment in service corporations and their subsidiaries, the parent thrift must follow one of four OTS reporting methods described in the instructions to the TFR (i.e., line-for-line consolidation, combination of consolidated first tier entities, equity, or cost). These reporting methods are not necessarily consistent with GAAP accounting methods.

A significant exception to GAAP, under OTS reporting requirements, is that service corporations and their subsidiaries are not consolidated with the parent thrift in the Unconsolidated Schedules of the TFR. For purposes of the unconsolidated Statement of Condition (Schedule SC) and Statement of Operations (Schedule SO), the equity or cost method under GAAP accounting is used to report the results of an association's investment in service corporations and their subsidiaries.

For purposes of the consolidated schedules, data is reported in two columns. The first column includes

all first tier service corporations and joint ventures. The second column includes all of the parent thrift's related organizations including those reported in the first column and operating and finance subsidiaries which are consolidated with the parent thrift on a line-by-line basis on unconsolidated TFR schedules.

For reporting data in the first column, a parent thrift that consolidates a first tier service corporation for GAAP purposes must incorporate the lower tier entities into the financial results of the first tier entity. When a parent thrift accounts for its investment in a first tier subsidiary by a method other than consolidation, the first tier and lower tier subsidiaries are not consolidated, but are reported in Schedule CSS (Consolidated Subsidiary Listing).

The following schedules are reported on a consolidated basis:

- Consolidated Statement of Condition (Schedule CSC) reports assets liabilities and capital;
- Consolidated Statement of Operations (Schedule CSO) reports income and expense;
- Consolidated Supplemental Information (Schedule CSI) reports asset quality, loan servicing, commitments, contingent liabilities, hedging activity, mortgage loan activity, and housing related balances;
- Consolidated Subsidiary Listing (Schedule CSS) reports information on all subsidiaries; and
- Consolidated Capital Requirement (Schedule CCR) reports calculations of capital requirements.

(For detailed guidance on evaluating the accuracy of reports filed with the OTS, refer to the TFR Instruction Manual.)

#### **Operating Subsidiaries**

As of November 30, 1992, all federal thrifts are authorized to establish or acquire one or more operating subsidiaries pursuant to § 545.81. Operating subsidiaries are subject to examination

and supervision by the OTS to the same extent as the parent thrift. State law should be analyzed to determine whether a state savings association can invest in an operating subsidiary.

#### *Definitional Requirement*

Section 545.81 defines *operating subsidiaries* as corporations that meet all of the following requirements:

- engages only in activities that a federal thrift is permitted to engage in directly;
- the parent thrift owns directly, or indirectly, more than 50% of the subsidiary's voting stock; and
- no person or entity other than the parent thrift may exercise "effective operating control" over the subsidiary.

The regulation does not identify scenarios under which "effective operating control" may be exercised. Through the notice and application processes and examination procedures, the OTS must analyze, on a case-by-case basis, specific facts and circumstances to determine whether such control is present.

In accordance with § 545.81, the parent thrift and its operating subsidiaries must be consolidated in accordance with GAAP, on a line-by-line basis, and treated as a single unit for purposes of reporting to the OTS and for applying appropriate regulatory requirements and limitations, unless otherwise stated by a specific regulation or policy.

Although operating subsidiaries are treated as a department of the parent thrift, they must maintain a separate corporate identity in accordance with the provisions of §§ 571.21 and 563.37 (as discussed in this Section under "Examination of Related Organizations").

#### *Purpose and Benefits*

The rationale for authorizing federal thrifts to establish operating subsidiaries is to provide thrifts with flexibility in structuring their operations. Section 545.81 also enables federal thrifts to have parity with national banks, which have been au-

thorized to invest in operating subsidiaries for quite some time.

An association may choose to form an operating subsidiary for, among other purposes: enhancing the thrift's ability to structure its operations to maximize efficiency and cost savings; managing some of its activities as separate businesses (with, for example, different employee schemes); pooling resources and spreading the cost of high overhead among several thrifts for such capital intensive services as data processing and maintenance of business records; insulating potential liability that would result if the activity were conducted directly by a parent thrift; using its investment to acquire interests in ongoing concerns or to acquire specialized knowledge from nonthrift sources; and attracting outside capital.

The following discussion outlines regulatory requirements for establishing or acquiring operating subsidiaries, highlights related issues on ownership structure, and compares operating subsidiaries and service corporations.

#### *Procedural Requirements for Investments in Operating Subsidiaries*

An association that is eligible for expedited treatment, as defined in 12 CFR § 516.3, must provide written notification to the OTS (§ 545.81) at least 30 days prior to establishing or acquiring an operating subsidiary, or performing new activities in an existing subsidiary.

The notification, at a minimum, describes how an activity will be funded, states the amount and form of the investment and the thrift's percentage of ownership, and lists the other shareholders. For acquisitions of existing subsidiaries, the notification also states the terms and conditions of the acquisition, provides documentation that supports the purchase price, and includes operating statements for the previous three years.

Section 545.81 requires thrifts that are ineligible for expedited treatment to obtain OTS written approval prior to establishing or acquiring an operating subsidiary, or conducting new activities in an existing subsidiary. Through the application process, an association must affirmatively demon-

strate that the establishment of an operating subsidiary or any proposed new activities will improve the financial and managerial condition or safe and sound operation of the parent thrift.

A thrift must also obtain approval under 12 USC § 1467 (Regulation of Holding Companies) and 12 CFR § 574.6 to hold another thrift as an operating subsidiary. Under this structure, OTS assessment fees are based on the parent thrift's consolidated assets and CAMELS rating. The thrift operating subsidiary is not separately assessed.

The regulator should verify that the subsidiary complies with representations made to the OTS and the approval order. Specifically, the regulator should determine how the subsidiary's activities affect the operations of the parent thrift. Documentation that supports the OTS' approval may be useful and should be on file at the thrift.

A service corporation in existence as of November 30, 1992, may be deemed an operating subsidiary merely by maintaining certain internal records if the corporation meets the definition of an operating subsidiary; and the parent thrift is eligible for expedited treatment under 12 CFR § 516.3. A parent thrift that is ineligible for expedited treatment must obtain prior OTS approval to change the status of a service corporation that existed on November 30, 1992, to an operating subsidiary. During the examination, the regulator must review and ensure that adequate documentation exists, including a certification by the parent thrift's board of directors. The certification must provide a description of the activity, how the activity will be conducted, and a statement of the authority that the thrift is relying on for the conduct of such activity.

To alter a subsidiary's status from an operating subsidiary to a service corporation, or if the operating subsidiary fails to continue to qualify as an operating subsidiary, the parent thrift must notify the OTS and comply with regulatory requirements relating to service corporations.

#### *Ownership Structure*

The parent thrift must hold more than 50% of the subsidiary's voting stock to qualify as an operating subsidiary. In addition, no other entity may exercise "effective operating control" over the

company. When an operating subsidiary is owned by more than one thrift, only the majority parent may treat the entity as an operating subsidiary.

The regulation does not establish restrictions on the composition and identity of an operating subsidiary's minority shareholders. The minority shareholders are subject to initial review through the notice and application processes prior to the establishment or acquisition of an operating subsidiary, and remain subject to OTS review through examinations and off-site monitoring. The subsidiary's management should be able to demonstrate that minority shareholders do not exercise effective operating control over the entity.

An operating subsidiary's authority to issue preferred stock is not limited by regulation. However, if an event occurs that would enable the preferred shareholders to exercise voting rights and assume effective operating control, the entity would no longer qualify as an operating subsidiary. Perpetual preferred stock issued by an operating subsidiary to third parties that constitutes a minority interest is included in line item SC-799 of TFR Schedule SC (Statement of Condition). Redeemable preferred stock issued to third parties is reported on line item SC-760 of Schedule SC.

The examination procedures include a thorough review of the organizational structure and any changes in ownership that have occurred since the prior examination. Discussions with management will provide the regulator with additional information regarding issues of control.

#### *Service Corporation Activities Compared With Operating Subsidiaries*

The following distinctions between service corporations and operating subsidiaries should be noted:

##### Activities Restrictions

As discussed previously, the activities of *service corporations* may be somewhat broader than those permissible for thrifts as long as they are "reasonably related" to the activities of a federal thrift. *Operating subsidiaries* are limited to the activities that federal thrifts are specifically permitted to engage in directly.

### Investment Limitations

A parent thrift's investment in its *service corporations* is generally limited to an amount that does not exceed 3% of the parent thrift's total assets. The federal regulations do not limit the amount that a parent thrift may invest in its *operating subsidiaries*. An investment limit for operating subsidiaries is unnecessary since no additional risk is presented by these subsidiaries because they may only engage in activities that are permissible for a federal thrift. The parent thrift's investment is reviewed during the examination. When a parent thrift's investment in its operating subsidiaries and related extensions of credit is determined to be excessive, the regulator should initiate measures to promptly address unsafe and unsound practices.

### Calculation of Certain Regulatory Limits

*Service corporations* are generally not consolidated with the parent thrift for calculating regulatory restrictions. Exceptions include those limits that are based on total capital, total assets and loans to one borrower or otherwise required by OTS policy or regulation. The parent thrift and its *operating subsidiary*, however, will be consolidated, on a line-by-line basis, and treated as a unit of the thrift for reporting to the OTS and for applying appropriate regulatory requirements, unless otherwise stated by regulation or policy. In other words, the parent thrift must calculate regulatory limits to make loans and investments after consolidating its assets and capital, and reconciling intercompany transactions with those of the operating subsidiary with respect to: consumer loans; commercial loans; service corporation investments; personal property investments; education loans; community development investments; nonconforming loans; and unsecured construction loans.

Other areas affected by the requirement to consolidate include: loans to one borrower provisions, reporting requirements (i.e., liquidity and interest-rate risk), and the qualified thrift lender test (provided the parent selects to include the subsidiary's assets in meeting this test). With respect to the provisions of the Community Reinvestment Act (CRA), the effect of an operating subsidiary on the parent thrift's CRA evaluation will depend on

whether the operating subsidiary is engaged in activities that are relevant for CRA purposes.

### Geographical Restrictions

Federal thrifts may only invest in *service corporations* chartered in the state where the parent thrift's home office is located. As a policy, however, the OTS differentiates among the various tiers of service corporations. First tier service corporations (directly owned by the parent thrift) must be chartered in the state where the parent thrift is headquartered while lower tier service corporations may be incorporated elsewhere.

In comparison, *operating subsidiaries* may be incorporated and operated in any geographical location where its parent may operate. An operating subsidiary that is a depository institution may accept deposits in any location, provided the subsidiary has federal deposit insurance.

### OTS Reporting Requirements

OTS reporting requirements for operating subsidiaries are distinct from those for service corporations. *Service corporations* are not consolidated with the parent thrift for purposes of preparing the parent thrift's unconsolidated TFR (Schedules SC through MR). These subsidiaries are consolidated with the parent in Schedules CSC through CCR (consolidated schedules). OTS reporting requirements concerning the thrift's investment in service corporations and their lower tier subsidiaries differs from GAAP. (Information on OTS reporting requirements is set forth in the TFR Instruction Manual.)

As stated above, *operating subsidiaries* are treated as a department of the parent thrift. These subsidiaries are consolidated on a line-by-line basis, after elimination of intercompany items, with the parent thrift for preparing the parent's unconsolidated TFR. Thus, the separate entities are reported as if they are one unit and the parent thrift's compliance with statutory and regulatory requirements is determined on a consolidated basis.

When a parent thrift owns another depository institution as an operating subsidiary, the associations must file separate TFRs with the OTS. The parent

thrift should not consolidate its subsidiary institution on a line-by-line basis for reporting purposes. The OTS will, however, accept an annual audit on a consolidated basis and not, as a policy, require a separate audit for the thrift operating subsidiary. The parent thrift must, however, calculate regulatory requirements and restrictions based on a line-by-line consolidation with its subsidiary.

### Finance Subsidiaries

In accordance with § 545.82, federal thrifts may establish one or more finance subsidiaries. The sole purpose of a finance subsidiary is to issue securities that a federal thrift may issue directly and remit the net proceeds of the issuance to the parent thrift. Finance subsidiaries are created through the transfer of assets or liabilities (collectively referred to as “transferred assets” for purposes of this Section) from the parent thrift to the subsidiary. Once established, the transferred assets are generally used as collateral for the subsidiary’s securities issuances.

The authority of state-chartered associations to establish a finance subsidiary is determined by state law. The regulator should review the laws of individual states in determining whether such authority exists. Section 563.132, however, defines a finance subsidiary to include a subsidiary of a state-chartered association that is in compliance with § 545.82. So, if a state-chartered thrift may establish a finance subsidiary, it is covered by the provisions of § 563.132. Therefore, the following discussion of federal regulatory requirements generally applies to state thrifts.

The creation of finance subsidiaries provides a means by which an association may reduce its interest-rate risk and control credit risk. Therefore, a review of the business plan and actual operations are important steps in determining whether the finance subsidiary is attaining its stated objectives.

Since the regulations governing a federal thrift’s authority to establish a finance subsidiary were first promulgated in 1985, subsequent statutory and regulatory provisions have eliminated some of the advantages for using finance subsidiaries. Most noteworthy is the effect of the OTS capital rule, implemented during December 1989, which eliminates the favorable capital treatment afforded to

these subsidiaries by requiring consolidation on a line-by-line basis with the parent thrift.

Finance subsidiaries continue to provide a means by which an association may build earnings, and obtain liquidity and capital, in accordance with a prudent plan for reducing interest-rate risk and credit risk. These goals can be achieved by the sale of an association’s assets through a separate subsidiary that is generally not subject to consolidation with its parent thrift if it becomes insolvent. This fact, combined with the high quality assets and minimal liabilities of such subsidiaries results in the subsidiary’s securities issuances generally being rated higher by national rating agencies than those of the parent thrift. This translates into reduced interest or dividend rates carried by the issuances, thereby providing a low cost source of cash flow for the thrift. Proceeds from the subsidiary’s securities issuances may be used by the parent thrift to make additional loans.

The higher ratings for the subsidiary’s securities can be attributed to the separate corporate structure of finance subsidiaries and the collateralization of most issuances providing greater protection to holders of the securities. Thus, the rating agencies focus on the assets collateralizing the securities rather than on the financial condition of the parent thrift. The regulator should review the ratings a security received when issued and note any changes that may have occurred since. A decline in ratings could indicate the marketplace’s awareness of problems. (For a discussion of rating definitions used by Moody’s and Standard & Poor’s refer to Handbook Section 540, Investment Securities.)

Another benefit provided through a finance subsidiary is that the parent thrift can remove “underwater assets” from its balance sheet by transferring the assets to its finance subsidiary. GAAP does not require thrifts to recognize losses upon a transfer of assets, yielding below market interest rates, to a wholly owned subsidiary. Assets transferred from the parent thrift may be used to collateralize the securities issuances of the subsidiary.

The restrictions imposed on asset transfers and other regulatory and procedural requirements associated with the formation, operation, ownership

structure, and transactions of finance subsidiaries are discussed below. The regulator should be able to assess the risk that a finance subsidiary affords the thrift by using the information presented in this Section.

#### *Finance Subsidiary Ownership Structure*

The common stock of a finance subsidiary must be 100% owned by the thrift capitalizing the subsidiary. The stock may not be transferred or assigned to any other person or entity without prior OTS approval. The regulations do not impose a similar restriction on the subsidiary's preferred stock that may be issued to persons and entities other than the thrift. Additionally, voting rights may be authorized for preferred shareholders, in certain circumstances for a limited period of time, as detailed under § 545.82(d).

#### *Procedural Requirements for Establishing a Finance Subsidiary*

Prior to establishing a finance subsidiary, the parent thrift must demonstrate, through a prudent business plan, that the subsidiary's operations will serve to reduce interest-rate risk and control credit risk. The thrift's board of directors must authorize, by resolution, the creation of the subsidiary and agree to make the subsidiary's books and records available to the OTS. In addition, the thrift must comply with the prior notification requirements of the OTS and the FDIC. Thrifts that are eligible for expedited treatment under § 516.3 must notify the OTS at least 30 days prior to establishing a new finance subsidiary, transferring additional assets to an existing subsidiary, or issuing additional securities through its subsidiary.

The regulator should compare the subsidiary's actual operations to those approved by the OTS. The notification must, at a minimum, include the amount of assets transferred and previous transfers from the parent thrift (including guarantees), and a calculation of the applicable asset-transfer limitation (amount representing 30% of the parent thrift's assets). The notification may also include a description of the securities to be issued, the estimated gross proceeds of the issuance, the current value of assets collateralizing the securities, or the anticipated interest or dividend rates and yields.

Thrifts ineligible for expedited treatment must, under § 545.82(f), obtain OTS approval prior to establishing a finance subsidiary, transferring additional assets to an existing subsidiary, or issuing additional securities through its subsidiary. The OTS approval takes the form of an order and may, for example, contain restrictions beyond those set forth in the regulations. Therefore, an assessment of whether the subsidiary complies with the approval order is an important aspect of the regulator's review.

#### *Transactions Between the Parent Thrift and Finance Subsidiary*

##### Asset and Liability Transfers Including Guarantees

Once proper notification or application has been made to the OTS, a federal thrift provides the capital to establish a finance subsidiary by transferring assets or liabilities to the subsidiary. The amount of assets transferred to the subsidiary are not subject to the loans-to-one-borrower limitations. The book value of transferred assets from the parent thrift to its subsidiary, however, may not, without prior OTS approval, exceed 30% of the thrift's total assets at the transfer date. Additionally, absent prior OTS approval, the market value of transferred assets may not exceed an amount necessary or customary for the securities to be issued, or 250% of the gross proceeds of the issuance, whichever is less.

In evaluating compliance with the asset transfer limitations, § 545.82(a) requires that the following be included to determine the aggregate amount of transferred assets:

- assets and liabilities used to capitalize the subsidiary, to collateralize a securities issuance, or to maintain collateral levels for a security issued by the subsidiary;
- guarantees issued by the parent thrift (with respect to securities issuances or any collateral for such guarantees);
- proceeds of a securities issuance that are held by the subsidiary for necessary expenses; and

- assets or liabilities received from the parent thrift in connection with the remittance of proceeds by the subsidiary.

The parent thrift's guarantees must state that the assets collateralizing the payment of the securities will be exhausted before recourse to the guarantor. Further, the thrift's guarantees may not exceed the sum of the unpaid principal balance plus accrued but unpaid interest, any redemption premium, and any post default interest on the securities. Also, for guarantees or transferred liabilities that are collateralized, the face amount (of the guarantee or liability) or the current book value of the collateral, whichever is greater, must be included in the amount of transferred assets.

The regulator should verify compliance with the transfer limitations and that the stated amount of transferred assets (book value) includes all assets actually transferred to the subsidiary. The transfer of an amount greater than 30% of assets would limit the parent thrift's ability to engage in other types of activities, particularly those for the provision of housing credit.

#### Remittance of Proceeds

The finance subsidiary is required to remit the proceeds of its issuance, net of reasonable costs, to the parent thrift. Reasonable costs include proceeds held in the subsidiary for collateral maintenance, fee payment, or any other necessary payments related to the issuance or collateralizing assets.

The regulator should verify that the remittance is occurring in a systematic manner and over a reasonable term. Proceeds can be remitted through:

- payment of dividends on common stock;
- redemption of common stock;
- repayment of any loan made as part of capitalization; or
- purchase of assets or liabilities issued by the parent thrift.

It is important to note that the remittance of proceeds does not reduce the amount of assets transferred to a finance subsidiary for purposes of the asset transfer limitation.

#### *Issuance of Securities by Finance Subsidiaries*

A finance subsidiary may issue, either directly or through a third party, any security that its parent thrift may issue directly. (A mutual thrift can establish a subsidiary to issue any securities that could be issued if the thrift were to convert to stock ownership.)

Section 545.82(f)(2) requires a parent thrift to notify the OTS within 10 days following the issuance of a security by its finance subsidiary. The notice should include a copy of a prospectus, offering circular, or other similar document. It is important to note that the subsidiary's securities may not be structured to accelerate payment, maturity, or redemption upon insolvency of the parent thrift or any receivership action taken by the FDIC.

Various types of financial instruments may be issued through finance subsidiaries, but a discussion of each type of security is beyond the scope of this Section. The specific advantages of issuing one type of security over another will vary depending on the objectives of both the thrift and the subsidiary. The regulator should review the thrift's business plan to determine whether the finance subsidiary is adequately meeting stated objectives. The most common forms of security issues through finance subsidiaries are preferred stock and collateralized mortgage obligations (CMOs).

#### CMOs

Through a CMO, the issuer transfers substantially all risks and benefits of ownership in the underlying mortgages to the investor. The actual risk assumed by the issuer depends on the frequency of principal and interest remittances to the investor, guarantees as to the maximum maturity of each class of securities, and any recourse obligations obtained by the thrift or subsidiary to absorb losses from the collateral on behalf of investors. (For a complete discussion of CMOs refer to Handbook Section 560, Deposits and Borrowed Funds, and Section 660, Derivative Instruments and Hedging.)

#### Preferred Stock

Under the OTS Capital Rule, a thrift may not include collateralized preferred stock as capital.

However, the issuance of collateralized preferred stock (frequently with variable market dividend rates) can still be attractive because of the tax advantage it provides to investors and the presence of a ready market for the issuances. Corporate investors can deduct a percentage of dividend income because, unlike debt, dividends are paid after taxes.

The regulator should review the subsidiary's reports pertaining to the terms of preferred stock issuances. This review is particularly important because mechanisms (unauthorized by the OTS) may exist whereby the shareholders can obtain voting rights. Through these unauthorized rights, an attempt may be made to replace the subsidiary's board of directors or sell subsidiary assets.

#### Oversight of Finance Subsidiary Activities

The thrift's board of directors must monitor the subsidiary's operations and performance on a regular basis. A finance subsidiary's activities must be solely limited to issuing securities that its parent thrift may issue directly. Any other activity could cause the entity to lose its status as a finance subsidiary and the benefits that accrue from its operation. Specifically, the subsidiary is prohibited from issuing or dealing in the deposits or savings accounts of its parent thrift, and may not state or imply that its securities are federally insured.

#### Representations Made to the OTS

Generally, the activities of a finance subsidiary are limited to the specific purposes for which it was created. The regulator should verify that the subsidiary has not incurred any other indebtedness, issued any other security, or used excessive levels (book value) of collateralization other than those essential to its limited function. Additionally, the board of directors should not authorize the subsidiary to issue securities that the thrift could more efficiently issue itself. The regulator can confirm that this has not occurred by verifying that a cost/benefit analysis was performed prior to the transfer of the assets to the subsidiary.

#### Objectionable Practices

While several legitimate benefits can accrue from the operation of a finance subsidiary, the regulator should be aware that these subsidiaries may be operated in a manner that is objectionable. For example:

The parent thrift capitalizes and lends funds to the subsidiary. The finance subsidiary locates an investment security to purchase with the intent of using the security to collateralize a CMO. Once the CMO is structured, the subsidiary consummates the transaction by simultaneously issuing the CMO and using the funds from the issuance to purchase the securities needed to collateralize the CMO. Additional collateral is provided by a loan to the subsidiary from the parent thrift.

In the example, the subsidiary is not purchasing the parent thrift's assets to collateralize the CMO offering, but is acquiring the assets from another entity. This transaction involves excessive leveraging of the parent thrift's assets. If the thrift includes the over-collateralization amount as the amount of assets transferred to the subsidiary and the subsidiary engages in a number of these issuances, the subsidiary could become larger than the parent thrift. This situation is considered an unsafe and unsound practice. The regulator can confirm that such practices are not occurring by verifying that the parent thrift has not exceeded the asset transfer limitation, as discussed above, without prior OTS approval.

Other potentially objectionable uses of a finance subsidiary include the: (1) transfer of marketable assets of a failing thrift into a finance subsidiary to collateralize the issuance of preferred stock or debt without OTS approval; (2) use of the finance subsidiary as a vehicle to provide tax losses for the thrift in order to generate a tax shelter for the holding company; (3) channeling or diverting of funds to other affiliates; and (4) use of the finance subsidiary as a device to permit otherwise prohibited transactions between a holding company, its subsidiary thrift, or other affiliates.

## EXAMINATION OF RELATED ORGANIZATIONS

The ability to distinguish between the types of related organizations and their different operating and regulatory requirements is important in evaluating the relationship between a parent thrift and its subsidiaries. That relationship is reviewed through the examination of related organizations. Specifically, related organizations are reviewed by the OTS to determine the degree of risk that they pose to the parent thrift.

Regulators should review related organizations as part of the parent thrift's examination and in a manner that is consistent with the philosophical approach and examination procedures outlined in this Section. A review of this Section will provide an understanding of:

- The approach to examining related organizations. The approach is risk-focused, though it differs in important respects from thrift examinations.
- The methodology for defining the scope of an examination. The scope is initially determined through a pre-examination analysis and should be sufficient to provide a thorough understanding of the level of risk that the related organization presents to the parent thrift.
- The procedures performed during the examination. These are used to evaluate specific activities and practices of the subsidiary and their overall effect on the parent thrift. The level of procedures performed depends on the risk presented by the activities of the related organization.
- The primary areas of review in examining related organizations are management quality, asset quality, earnings and compliance. Examination procedures are used to evaluate these areas within the defined scope and, based on findings revealed, may lead to additional levels of review.
- The considerations for identifying and evaluating conflicts of interest. Related regulatory restrictions (i.e., usurpation of corporate opportunity, tie-in arrangements, loans to insiders)

are also discussed. A response to violations should be initiated to minimize the effect of improper practices on the parent thrift.

- The requirement of separate corporate identities for a parent thrift and its subsidiaries. While only a court of law may determine when a parent thrift may be liable for the debts of a subsidiary, there must be a review of potential or ongoing litigation to estimate the parent thrift's loss exposure attributable to the related organization's activities.
- The documentation process for examination findings. A single CAMELS composite rating is assigned to all related organizations based on the combined risk presented to the parent thrift.

Several sections of this Handbook are referred to or incorporated by reference. The guidance contained in these sections can be applied to the examination of both the parent thrift and its related organizations. Guidance pertaining to major activities (i.e., securities brokerage, real estate development, insurance) conducted through related organizations is provided in Handbook Sections 710, 720, and 740. Information on the review of mortgage banking operations is detailed in Handbook Chapter 570, Mortgage Banking.

### Approach

A thrift's conduct of activities through a related organization can involve complex management issues, legal obligations to honor the organization's debts if separate corporate identities are not maintained, or a negative effect on the parent thrift's consolidated income stream. Conversely, related organizations may serve to isolate risky activities in a separate corporate entity, allow geographic expansion or joint investment opportunities with other thrifts, and provide increased consolidated earnings.

### *Examination Philosophy*

The primary purpose of examining related organizations is to evaluate the level of risk that these entities pose to the parent thrift and thereby the insurance fund. The examination procedures at the end of this Section highlight the following four primary areas of review:

- management quality;
- asset quality;
- earnings analysis; and
- compliance.

In performing an examination, a risk-focused approach, similar to a “due diligence” approach should be employed. Due diligence is defined as the amount of activity ordinarily exercised and reasonably expected from a prudent and reasonable person. Due diligence is determined by the facts of each case and is not measured by an absolute standard. As applied to the examination of related organizations, due diligence suggests that the potential risk of loss to the parent thrift will determine the scope of the examination.

The foregoing examination philosophy does not mandate great detail, but serves to ensure that the scope of these examinations is both reasonable and prudent. Thus, the regulator should tailor the examination to the specific activities of the organization and identified areas that present material risk.

#### *Levels of Procedures*

Consistent with the risk-focused approach to reviewing related organizations, the examination procedures have been tiered into two levels. The level of procedures performed during an examination will depend on the types of activities conducted through subsidiaries and the materiality of the risk involved. Handbook Sections 710, 720, and 740 contain three tiers of examination procedures that may be used to evaluate activities commonly conducted through related organizations.

Level I procedures are usually performed at each examination and enable the regulator to obtain an overview of the organization’s condition and the parent thrift’s risk exposure. These procedures include a general analysis of management, financial statements, organizational structure, and compliance with regulatory requirements. Information revealed through a Level I examination may require further review and modifications to the examination scope to incorporate Level II procedures.

Level II procedures provide an in-depth analysis of a related organization. The procedures are only performed when an initial analysis reveals that the parent thrift may be exposed to substantial risk and should be tailored to address specific areas of concern. The appropriate level of review is initially determined through the examination scoping process. The level of review may be modified throughout the examination as additional information is evaluated and findings reveal the need for further analysis.

#### **Examination Scope**

##### *Pre-Examination Analysis*

The first step in establishing the examination scope is to conduct a pre-examination analysis to define the appropriate level of review. Information relevant to the analysis can be obtained from the following sources:

- Preceding examination reports and recent supervisory correspondence may highlight issues pertinent to the review.
- The Continuing Examination File (CEF) should contain copies of the charters, existing contracts and information on the related organizations’ relationships with the parent thrift and other entities.
- Recent Thrift Financial Reports (TFR) of the parent thrift include a list of the parent thrift’s subsidiaries and their activities, the amount of investment in subsidiaries and changes in that amount, and material variances or unusual conditions relevant to the organization’s operations.
- The Preliminary Examination Response Kit (PERK) should be reviewed to identify recent events that may affect the subsidiary’s operations. The entity’s audited financial statements should be provided with the PERK.
- The related organization’s business plan and pro forma statements set forth underlying assumptions to be considered, as well as operating strategies. A review of the parent thrift’s business plan may indicate the purpose

and objectives for investing in the related organization(s).

- Discussions with management of the related organization and parent thrift may disclose important plans or other information. Management is responsible for providing any additional information pertinent to the analysis.

The pre-examination analysis should lead to an initial examination scope that is broad enough for the regulator to obtain an accurate understanding of the parent thrift's organizational structure, related activities, and the materiality of the risk involved.

In performing an initial assessment of the potential risk that a related organization poses to its parent thrift, the following factors should be considered:

- the relative size (assets, capital, earnings, cash flow) of the parent thrift and subsidiary;
- the perceived risk of activities;
- the significance of debt and equity investments (Are they includable in regulatory capital?);
- the significance of contingent liabilities;
- the number of related organizations; and
- the cost of the examination in relation to the information to be gained.

### Organizational Structure

Understanding the thrift's organizational structure is also a key element when defining the examination scope. Primary sources of information include the Consolidated Subsidiary Listing (CSS) of the TFR, the PERK, and discussions with management of the related organization and parent thrift.

An assessment of organizational structure will help to determine the effect of any changes on future operations or viability of the related organization, identify risks to the parent thrift, and assist in establishing the examination scope. For example, if substantive changes in organizational structure have not occurred since the previous examination, the review may be limited to an update of ownership interests. For an inactive organization, the examination can generally be limited to verifying

ownership interests and determining management's plans for selling or retaining the entity.

In the event that there have been changes in organizational structure or related activities since the prior examination, a re-evaluation of the related organization's operations and the effect on the parent thrift may be necessary. In evaluating the fit between structure and strategy, the regulator should:

- identify the organizational structure of the parent thrift and its related organizations;
- determine if the organizational structure is adequate for the pursuit of current activities;
- determine transactions and arrangements among entities within the organizational structure;
- determine the effect of changes on the related organization's operations; and
- identify deficiencies in organizational structure and alert management and the board to potential or existing problems in order to minimize the effect on the thrift.

A primary aspect in the foregoing analysis is how well the structure's organization compliments its activities. Factors that influence whether an organizational grouping is practical include the size, number, and location of organizations. The following characteristics, while not all inclusive, are indicative of an effectively organized group of related organizations: operating synergies exist; activities are easily monitored; and diversification is used to isolate risk.

This review of the coordination between the parent and its related organization is a key component in assessing the effectiveness of the organizational structure. The exposure to losses increases if the groups are not well organized, are too large or diverse, or are poorly controlled or monitored.

### **Evaluation of Primary Examination Areas**

The pre-examination analysis and a review of the organizational structure provide the basis for determining the initial estimate of risk presented to

the parent thrift. This estimate determines the examination scope. Guidance pertaining to the pre-examination analysis and establishing an examination scope is provided in further detail under Section 060, Examination Strategy, Management, and Scoping.

The following primary areas of review are to be performed in accordance with the planned scope of the examination and the recommended level of procedures.

#### *Management Quality*

An understanding of executive management, including the board of directors, is essential to determine the effectiveness of the related organization's operations. Management's ability to implement goals, manage activities, and maintain an appropriate level of expertise will substantially affect the organization's success in meeting business plan projections and minimizing risk to the parent thrift. A review of the quality of management is necessary to:

- determine management's effect on the subsidiary's operations;
- gauge the resulting effect on the parent thrift; and
- detect ways in which the parent thrift affects the organization.

The quality of the related organization's management influences all phases of the subsidiary's operations and its ability to provide services. The related organization's financial soundness often depends heavily on management's capabilities and expertise. Additionally, management affects the entity's ability to implement corrective measures and respond to oversight recommendations by outside parties (i.e., the parent thrift, owners, independent auditors, regulators). A more detailed discussion on evaluating management is provided in Handbook Section 330, Management Assessment.

#### *Asset Quality Analysis*

Executive management is responsible for taking appropriate measures to minimize risk inherent in the related organization's asset portfolio. These

measures include ensuring that expertise is adequate relative to the organization's activities, implementing prudent policies and procedures, and adhering to internal asset review systems. Substantial risk exposure within the asset portfolio reflects poorly on management's ability to operate the subsidiary in a prudent manner.

There is a direct correlation between a related organization's effectiveness in acquiring and managing its assets and the thrift's long run return on investment in the entity. Therefore, reviewing the composition and soundness of the assets is necessary to analyze and assess risk to the parent thrift, as capital rules permit inclusion of related organizations' assets (or the thrift's investment in the organizations) in the determination of regulatory capital. Guidance on evaluating asset quality is provided in detail in Handbook Chapter 200, Asset Quality. The following discusses the purpose and aspects of reviewing a subsidiary's asset portfolio.

The primary objective in analyzing the related organization's asset quality is to determine and minimize loss exposure to the parent thrift. Additionally, the regulators should evaluate whether (1) the actual realizable value of an asset is fairly represented on a related organization's books; and (2) the protection against losses is commensurate with the degree of risk in an organization's portfolio. Specifically, the following should be considered:

#### Asset Underwriting

The regulator is concerned with whether management has sufficiently underwritten a particular activity or asset. The general characteristics of underwriting practices and standards are the same as those for the parent thrift, as discussed in Handbook Section 260, Classification of Assets. A key factor in the assessment of asset underwriting is an evaluation of the organization's policies and procedures.

#### Internal Asset Review and Classification Systems

These systems allow for early identification of existing and potential risks within the portfolio so that prompt measures may be implemented to minimize losses (see Handbook Section 260, Clas-

sification of Assets). The asset quality review generally involves sampling the organization's asset portfolio and estimating the risk of loss exposure as compared to management's estimates. (Refer to Handbook Section 209, Sampling.)

#### Methods of Determining Value

Assets must be accurately reported on the related organization's financial statements in accordance with GAAP. A sampling of asset values should assist in determining whether adjustments to asset values are correctly reported in the subsidiary's financial statements. Management should be notified of differences revealed in the review and provided with supporting documentation.

#### Valuation Allowances

The analysis of asset quality at the related organization level may be material to estimating loss and risk exposure to the parent thrift and potentially to the insurance fund. Related organizations should follow GAAP requirements for maintaining reasonable valuation allowances through periodic charges to income. The adequacy of valuation allowances should be evaluated in accordance with guidance set forth in Handbook Section 261, Adequacy of Valuation Allowances.

Review and classification of a thrift's investment in a subsidiary may be unnecessary when appropriate allowances have been recorded by the subsidiary and reflected on the thrift's books by reducing its equity investment.

Note: Subsidiary assets should be reviewed and may be adversely classified if consolidated by the thrift on a line-by-line basis (i.e., operating and finance subsidiaries). If the equity method of accounting is used to carry the thrift's investment in the related organization (i.e., service corporations, including their lower tier subsidiaries, and joint ventures or limited partnerships) as an asset, then the thrift's investment in the subsidiary should be reviewed and may be adversely classified. (See Handbook Section 260, Classification of Assets.)

If neither the thrift's investment in, nor the assets of, the related organization are includable in regulatory capital, then the effect of adverse

classification is immaterial to the regulatory effort. The findings revealed through the asset quality review may, however, have an effect on the organization's reported financial condition and operating results. These findings should be incorporated into the analysis of the subsidiary's financial condition to determine the effect on the thrift's financial reporting.

#### *Earnings Analysis*

This area of the examination involves analyzing the financial condition of related organizations. Earnings analysis is an integral part of the evaluation of a related organization and plays a critical role in identifying strengths, weaknesses, and areas of risk throughout the subsidiary. Earnings analysis is, therefore, a key element in assessing the subsidiary's effect on the parent thrift.

The regulator should refer to Handbook Chapter 400, Earnings, for guidance on analyzing operations. This guidance and relevant examination procedures enable the regulator to:

- establish the scope of the financial analysis aspect of the examination;
- identify practices that are potentially unsafe and unsound and formulate appropriate regulatory responses;
- assess the organization's operations and strategies;
- identify problem areas disclosed by the financial records; and
- obtain satisfactory explanations for all material variances of data from prior periods and budgeted amounts.

#### Accuracy of Reporting

Earnings analysis also involves assessing the accuracy and adequacy of the related organization's financial reports and records. Accurate reporting by the related organization is necessary to effectively monitor and evaluate the entity's operations, financial condition, and effect on the parent thrift. Guidance relevant to the review of financial statements and accuracy of reporting practices is

detailed in several Handbook sections (Section 410, Financial Records and Reports, Section 430, Operations Analysis). The OTS' reporting standards are detailed in the TFR Instruction Manual.

The discussion of the different types of related organizations addresses the regulatory and GAAP standards for reporting a thrift's investment in related organizations. Additionally, the regulator should verify that the thrift's investment in its subsidiaries is accurately reported in the calculation of OTS capital requirements. For purposes of the OTS Capital Rule (Part 567) and Schedule CCR (Consolidated Capital Requirement), a subsidiary is either "includable" or "nonincludable." The following is provided to highlight the distinctions between includable and nonincludable subsidiaries. For purposes of verifying the accuracy of Schedule CCR, the regulator should refer to Handbook Section 120, Capital Adequacy, the TFR Instruction Manual, and 12 CFR Part 567, the OTS Capital Rule.

- **Includable Subsidiaries**

Includable subsidiaries are those that are:

- engaged solely in activities permissible for a national bank;
- engaged in activities not permissible for a national bank, but solely as agent;
- engaged solely in mortgage banking activities;
- an insured depository institution or a holding company whose sole investment is an insured depository institution (acquired directly or indirectly by the thrift before May 1, 1989); or
- a subsidiary of a federal thrift existing as such on August 9, 1989, and was either previously chartered by a state savings bank prior to October 15, 1982, or acquired its principal assets from a state savings bank prior to this date.

Includable subsidiaries that are consolidated under GAAP are consolidated with the parent thrift for purposes of the capital standards. The subsidiary's assets are risk weighted in the same manner as the

parent thrift's assets. When a thrift has an ownership interest in an includable subsidiary that is not consolidated under GAAP, the consolidation is prorated for purposes of calculating tangible assets (defined under § 567.1), but not for regulatory capital.

- **Nonincludable Subsidiaries**

In general, these subsidiaries are engaged in activities that are impermissible for national banks. Section 567.9 (Capital Requirement) requires that a thrift's investments in (and loans to) nonincludable subsidiaries, made after April 12, 1989, be excluded from assets and capital, unless grandfathered.

Grandfathering provisions for subsidiaries engaging in impermissible activities, prior to April 12, 1989, are detailed in Part 567, OTS Capital Rule, and the TFR Instruction Manual. These provisions provide a transition period during which thrifts must exclude from assets and regulatory capital an increasing percentage of their investments in (and loans to) nonincludable subsidiaries. By July 1994, all investments in nonincludable subsidiaries must be excluded from assets and regulatory capital unless OTS prior approval is obtained to include the appropriate percentage of investment in certain real estate subsidiaries for a period after July 1994, but not to extend beyond June 1996. Thus, any investments in nonincludable real estate subsidiaries must be excluded from the thrift's assets and capital after July 1, 1996.

In addition to determining the overall financial condition of the related organization, the operations analysis can be an important source of information for the compliance review. The analysis should be particularly useful in determining whether the related organization's actual activities and operations are consistent with representations made to the OTS through the notification or application process, financial statements and other documents filed with the OTS.

### *Compliance With Regulatory Requirements*

The purpose of the compliance review is to determine whether a related organization is in

compliance with relevant statutes, regulations and OTS agreements. Compliance encompasses the entire body of regulations with which related organizations must comply. Primarily, the regulator must determine whether the related organization:

- was established or acquired in accordance with applicable regulations and related policies;
- engages in only those activities or businesses that are authorized by law, regulation, or other authority (i.e., OTS or FDIC approval); and
- conducts activities or businesses in accordance with pertinent requirements as set forth in the regulations (including consumer regulations), policy statements, and OTS agreements.

The regulator should refer to the individual discussions on specific types of related organizations and their permissible activities. This will provide an understanding of the relevant regulatory requirements and additional issues to consider when conducting the compliance review.

### **Additional Regulatory Concerns**

There are additional concerns that could be revealed in any one of the four areas of the related organization review. These include the existence of conflicts of interest and the failure to maintain separate corporate identities. These concerns are addressed in § 571.7 (Conflicts of Interest) and §§ 563.37 and 571.21 (Maintenance of Separate Corporate Identities). In addition, the OTS may address related supervisory concerns through its broader authority to prohibit unsafe and unsound practices.

### *Conflict of Interest Considerations*

Conflicts of interest occur when the interests of an association clash with the personal interests of individuals or the business interests of entities associated with the thrift. Section 571.7 describes conflicts of interest as conflicts between the financial interests and soundness of thrifts and the personal financial interests of directors, officers, and other controlling persons, their families and their business interests.

Conflicts of interest frequently occur through related organizations for several reasons, including:

- related organizations typically receive less scrutiny from outside auditors and boards of directors than the parent thrift;
- recordkeeping can be incomplete and auditors and directors may hold related organizations to a lower recordkeeping standard (i.e., in terms of documentation, disclosure of transactions, board of directors minutes) than the parent thrift; and
- complex organizational relationships (i.e., multi-tier subsidiaries) between the thrift and its subsidiaries make transactions difficult to identify.

### Conflict of Interest Policy

Although it is not a regulatory requirement, thrifts and their related organizations should develop a policy on conflicts of interest and a code of conduct for their officers and other employees. The existence of such a policy is particularly important if a strong potential for conflict exists (i.e., the thrift is owned or controlled by a real estate developer). Regulators can identify conflict of interest policies through written policies, board minutes, and interviews with management of the thrift or related organization. The mere existence of a conflict of interest policy does not, however, prevent conflicts of interest.

### Indications of Abuse

Determining the existence of conflicts of interest is an important aspect of the related organization examination. Certain red flags that suggest potential conflicts of interest include: recordkeeping deficiencies; evidence of concealment of insiders' interests in certain transactions; frequent changes in auditors and legal counsel; frequent appearance of insiders' names on suspense item listings; and expense accounts with expenditures that do not correspond to services rendered.

Regulatory Prohibitions

In addition to identifying specific abuses, the regulator should be familiar with the following regulations:

- **Usurpation of Corporate Opportunity (§ 571.9):** One common and often subtle type of conflict of interest is usurpation of corporate opportunity. It is a breach of duty for an officer or director of a thrift to take advantage of a business opportunity for his or another person's personal benefit when the opportunity is within the corporate powers of the thrift or its subsidiary.

The opportunity must also be of present and practical benefit to the thrift. Examples of usurpation of corporate opportunity by directors and officers include: (1) purchasing real estate from a related organization at a below market price, or (2) engaging in business activities authorized for the parent thrift.

Additionally, § 571.9 stipulates that the thrift or its related organization is entitled to any benefit that arises from usurpation of corporate opportunity. The person or entity involved is also exposed to liability in this regard.

- **Tie-in Prohibition (§ 563.35(a)):** An association or its subsidiary may not grant loans on the prior condition that borrowers contract with any specific company for:
  - insurance services;
  - building materials or construction services;
  - legal services;
  - real estate agent or broker services; or
  - real estate property management services.

[*Note:* See 12 USC § 1464(5)(q), Tying Arrangements.]

- **Restrictions on Loan Procurement Fees, Kickbacks and Unearned Fees (§ 563.40):** Directors, officers, or controlling persons of the parent thrift, their immediate family members, and

their business interests, as defined in the regulation, are prohibited from receiving fees or other compensation in connection with the procurement of loans.

- **Loans by Thrifts to their Executive Officers, Directors and Principal Shareholders (§ 563.43):** The insiders of a thrift or its related organizations are subject to the restrictions contained in the Federal Reserve Board's Regulation O, 12 CFR § 215. This regulation governs extensions of credit by a thrift, or its subsidiary, to executive officers, directors, principal shareholders and their related interests.
- **Loans and other Transactions with Affiliates (§ 563.41 and § 563.42):** These regulations place quantitative and qualitative restrictions on loans or certain other transactions entered into by the thrift or its subsidiaries with non-subsidiary affiliates. (Refer to Section 400 of the Holding Companies Handbook for a detailed discussion on transactions with affiliates.)

OTS recognizes that it is impractical to identify every practice or condition that constitutes a conflict of interest. The absence of specific prohibition does not, however, imply tacit approval or permission of conflicts. (Refer to Handbook Sections 330, Management Assessment, and 360, Fraud/Insider Abuse, for additional information on conflict of interest considerations.)

*Maintaining Separate Corporate Identities*

In examining a related organization, the regulator must ensure that the parent thrift and its related organization maintain separate corporate identities. A separate corporate identity distinguishes the activities of the subsidiary from those of the parent thrift in a visible and obvious manner. Corporate separation protects the parent thrift from the debts and other liabilities of its related organizations. Based on this protection, litigation involving the subsidiary may not result in legal liability to the parent thrift. The parent thrift can lose this protection if a court of law finds that corporate separation has not been maintained.

At all times, a parent thrift should ensure that the separate corporate existence of its related organi-

zations is maintained. To facilitate the regulator's review of this area, a request should be made for a written representation (or legal opinion from the parent thrift) that it and the subsidiary conform to the OTS policy on maintenance of separate corporate identities in §§ 563.37 and 571.21.

#### Legal Status of Review

The regulator's review of corporate separability could be used as evidence in a court of law. Since the legal definition of separate corporate existence varies from state to state, the regulator should be aware of local precedent. Considerable legal expertise, familiarity with recent court cases, and knowledge of the state's law are required to reach a legal opinion on corporate separability. Therefore, the regulator should not reach a conclusion that the entities are not separate, but should focus on whether specific guidelines have been met and identify conditions that could give rise to a court finding that separate corporate identities are not maintained. If such an adverse finding is made, supervisory action should be taken to minimize or negate the effect on the parent thrift and the insurance fund.

#### Regulatory Standards

Section 571.21 contains five guidelines that provide a minimum standard for the maintenance of separate corporate identities including:

- The thrift and its related organizations should operate without intermingling their respective business transactions and keep separate accounts and records;

*Note:* Each related organization should maintain its own separate records that reflect only the transactions of that entity. Neither the subsidiary nor the parent thrift should have access to each other's files. For example, an insurance subsidiary should not have access to the appraisals in the loan files of the parent thrift.

Additionally, written management agreements between the subsidiary and the parent should specify the types of services that the parent is providing for its subsidiary and the specific costs of the services (such costs should be reasonable).

It is also noted that the bonding of an association and its wholly owned subsidiary in a single bond would not, in itself, compromise the separate corporate existences of the two entities. Further, related organizations may originate loans in the name of the parent provided the approval process is conducted by the parent thrift.

- The parent thrift and the subsidiary should observe separate corporate procedures;

*Note:* Each corporation should have a separate board of directors and should maintain separate minutes of board meetings that clearly identify and distinguish between the activities of each entity.

- Each related organization should be adequately capitalized with sufficient funds to operate as a viable business;
- Each subsidiary should be held out to the public as a separate corporation (mandatory under § 563.37); and

*Note:* For example, a subsidiary's office space should be clearly separate from that of its parent. All lease or rental contracts should reflect this separation. The name of the subsidiary should be sufficiently displayed on signs, doors, and letterheads to clearly identify the separate corporation. Advertising in mailings, newspapers, and other media should communicate that the related organization is providing the service and not the thrift. In-branch promotional materials should be displayed or distributed where the subsidiary's activities are conducted, and not where banking activities occur (i.e., teller windows, loan desks). There should not, for example, be any confusion as to whether the related organization's products and services are FDIC-insured. (Refer to TB 23-2 for a discussion of investment product sales activity conducted on the thrift's premises.)

- The parent thrift should not excessively dominate its subsidiary.

#### *Assessing the Effect of Noncompliance*

Considerations relating to the failure to maintain separate corporate identities include:

### Piercing the Corporate Veil

Generally, a shareholder of a corporation is not liable for the debts of the corporation unless the shareholder guarantees an obligation of the corporation. A shareholder's liability is limited to the amount paid for the stock. In certain cases, however, a court may determine that a shareholder is liable for the debts of the corporation. This determination is due to "piercing the corporate veil," such that the shareholder and the corporation are recognized by a court as one entity.

Although courts do not normally determine that the corporate veil has been pierced where separate corporate entities exist, there have been rare instances of such rulings. Therefore, the related organization should be structured and operated so as to prevent creditors of an insolvent subsidiary from obtaining a court decision holding a parent thrift liable for the debts of the subsidiary. The corporate veil is most likely to be deemed pierced by a court when the parent thrift initially capitalizes a related organization in a grossly inadequate amount for the type of business to be conducted and the operations of a subsidiary are conducted as an operation of the parent thrift rather than as a separate and distinct entity.

### Potential Litigation

Actual or pending litigation concerning corporate separation could have a significant effect on the financial position of the parent thrift. When corporate separation is not maintained, the parent thrift could become liable for damages awarded or alleged in litigation against the related organization. Where a court finds that the corporate veil has been pierced, damages that are beyond the related organization's and parent thrift's ability to pay may result in losses to the insurance fund.

The existence of past or pending litigation against the thrift concerning corporate separation should be determined by reviewing attorney letters, board minutes, and audit reports. Additional information on litigation should be obtained through a discussion with management. The actual and potential costs to the insured thrift should be identified using these primary sources: records of the parent thrift

and its subsidiary; appraisals; and attorney letters to regulators, the thrift, or the related organization.

The process by which the total potential costs are estimated should be carefully explained and documented. Any actual losses should be properly accounted for in the parent thrift's financial records. If the actual or potential losses are significant, consideration should be given to submitting an interim report in accordance with policies and procedures of the regional office.

### **Documenting Examination Findings**

As detailed in this Section, the related organization's practices, activities, and financial condition, will generally determine the scope of review. An understanding of the distinctions between related organizations and the risk-focused review of these entities provide a framework for formulating conclusions regarding the degree of risk presented to the parent thrift.

The regulators' conclusions should be documented in the parent thrift's ROE along with supporting data. The ROE contains a supplemental page titled Related Organizations. Major issues identified during the organization's examination should be noted on the Examination Conclusion and Comments page of the parent thrift's ROE with a reference to specific comments and conclusions included in the supplementary page.

The risk-focused approach to documenting the related organization review differs from the comprehensive approach employed for thrift examinations (See Handbook Section 070, Overall Conclusions). The conclusions pertaining to the related organization's operations should primarily be limited to addressing the degree of risk presented to the parent thrift. The regulators' conclusions should be based on information set forth in self-contained work papers that clearly state the purpose of a particular area of review. (For guidance on completing work papers, see Handbook Section 011, Program Use.)

After the comments and report papers are prepared, related organizations are assigned a subfactor rating based on the combined risk that they pose to the parent thrift. The rating is based on the numerical scale of the CAMELS system (re-

fer to Handbook Section 071, CAMELS Ratings) and is included under the earnings section of the ROE. The subfactor rating should reflect the conclusions drawn by the regulators with regard to the risks posed by the related organizations' operations. (For a detailed discussion of the thrift examination process, see the Handbook Chapter on Administration. This chapter addresses the use of this Handbook, discussions with management, conduct of Agency personnel and so forth.)

## REFERENCES

### United States Code

#### *Home Owners' Loan Act (12 USC)*

§ 1464(c)	Loans and Investments
§ 1464(q)	Tying Arrangements
§ 1464(u)	Limits on Loans to One Borrower
§ 1468(a)	Affiliate Transactions
§ 1468(b)	Extensions of Credit to Executive Officers, Directors, and Principal Shareholders
§ 1468b	Powers of Examiners

#### *Federal Deposit Insurance Act (12 USC)*

§ 1828(m)	Activities of Thrifts and Subsidiaries
§ 1831e	Activities of Savings Associations

#### *Housing and Urban Development Act of 1968 (42 USC)*

§ 3931 et al.	National Housing Partnerships
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### Code of Federal Regulations (12 CFR)

#### *FDIC Rules and Regulations*

§ 303.13(d)	Equity Investments
§ 303.13(e)	Corporate Debt Securities not of Investment Grade
§ 303.13(f)	Notice of Acquisition or Establishment of a Subsidiary or the Conduct of New Activities Through a Subsidiary

§ 303.13(g)	Notice by Federal Associations Conducting Grandfathered Activities
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### OTS Rules and Regulations

#### *Subchapter A: Organization and Procedures*

§ 516	Application Processing Guidelines and Procedures
§ 516.3	Definitions (Expedited and Standard Treatment)

#### *Subchapter C: Regulations for Federal Savings Associations*

§ 545.46	Commercial Loans
§ 545.74	Service Corporations
§ 545.77	Real Estate for Offices and Related Facilities
§ 545.81	Operating Subsidiaries
§ 545.82	Finance Subsidiaries
§ 545.126	Referral of Insurance Business

#### *Subchapter D: Regulations Applicable to All Savings Associations*

§ 561.4	Affiliate
§ 561.45	Definition of Service Corporation
§ 561.46	Definition of Service Corporation Affiliate
§ 563.35(a)	Tie-in Prohibitions
§ 563.37	General; Operation of Service Corporation, Liability of Savings Associations for Debt of Service Corporation
§ 563.37(b)	Service Corporation Debt
§ 563.37(c)	Notice of New Activity
§ 563.38	Salvage Power of Savings Association to Assist Service Corporation
§ 563.40	Restrictions on Loan Procurement Fees, Kickbacks and Unearned Fees
§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries

§ 563.42	Additional Standards Applicable to Transactions with Affiliates (Section 23B)	TB 23-2	Interagency Statement on Retail Sales of Nondeposit Investment Products
§ 563.43	Loans by Savings Associations to their Executive Officers, Directors and Principal Shareholders		<b>Federal Home Loan Bank Board T Memoranda Series</b>
§ 563.44	Loans Involving Mortgage Insurance	T 79a	Indirect Investments in Permissible Investments Through Limited Partnerships
§ 563.76	Offers and Sales of Securities at an Office of a Savings Association		
§ 563.93	Lending Limitations		
§ 563.100	Real Estate Lending Standards (Includable Subsidiaries)		<b>Accounting Practices</b>
§ 563.101	Real Estate Lending Standards		<i>Financial Accounting Standards Board, Statement of Financial Accounting Standards (SFAS)</i>
§ 563.132	Securities Issued Through Subsidiaries		
§ 563.160	Classification of Certain Assets	No. 05	Accounting for Contingencies
§ 563.161	Management and Financial Policies	No. 11	Accounting for Contingencies - Transition Method
§ 563.170	Examination and Audits; Appraisals; Establishment and Maintenance of Records	No. 34	Capitalization of Interest Cost
§ 563.171	Compensation	No. 58	Capitalization of Interest Cost in Financial Statements that Include Investments Accounted for by the Equity Method
Part 567	Capital		
§ 571.7	Conflicts of Interest	No. 66	Accounting for Sales of Real Estate
§ 571.9	Usurpation of Corporate Opportunity	No. 94	Consolidation of all Majority Owned Subsidiaries
§ 571.21	Separate Corporate Existence of a Service Corporation		<i>Accounting Principles Board, Opinions (APBO)</i>
§ 574.6	Acquisition of Control of Insured Associations (Procedural Requirement)	No. 18	The Equity Method of Accounting
		No. 23	Accounting for Income Taxes - Special Areas (Undistributed Earnings of Subsidiaries and Investments in Corporate Joint Ventures)
			<i>Committee on Accounting Procedure, Accounting Research Bulletins (ARB)</i>
		No. 51	Consolidated Financial Statements
<i>Subchapter F: Regulations for Savings and Loan Holding Companies</i>			
§ 584.2-1(d)	Service Corporation Subsidiaries		
<b>Office of Thrift Supervision Bulletins</b>			
RB 18	Issuance of Enforcement Policies		
RB 30	Guidance on the Use of Salvage Powers to Exceed Loans to One Borrower Limitations		
TB 23a	Sales of Securities		