Table of Contents - Holding Companies Handbook

Section 100 – Supervisory Approach

This section outlines OTS's supervisory approach to holding companies. It provides a historic perspective on holding company regulation, and outlines our authority.

Section 200 – Administration

This section sets forth the more procedural aspects of scoping and performing an examination. The classification of holding companies into risk category is covered, as well as rating, examination and report requirements.

- *Appendix 200A* – Holding Company PERK – *To be Issued at a Later Date*
- *Appendix 200B* – Holding Company ROE Shell

Section 300 – Capital

This section outlines the factors, including debt, relevant to capital that examiners will review in determining its adequacy.

Section 400 – Organizational Structure

This section provides guidance in identifying and assessing the risk of non-thrift activities and investments of the holding company enterprise. Issues regarding ownership of the thrift are also addressed within this section.

Section 500 – Relationship

This section highlights the importance of accurately assessing the degree of influence the holding company has over the thrift and how this influence affects the thrift's operations.

- *Appendix 500A* – Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure

Section 600 – Earnings

This section addresses the earnings and profitability, liquidity, and cash flow aspects of the financial analysis of a holding company.

Table of Contents – Holding Companies Handbook

Section 700 – Holding Company Programs

- *Section 710* – Holding Company Administrative Program
- *Section 720* – Abbreviated Holding Company Examination Program
- *Section 730* – CORE Holding Company Examination Program

Section 800 – Off-site Monitoring *– To be Issued at a Later Date*

Section 900 – Specialized Holding Company Populations

- *Section 910* – HOLA 10(l)s – *To Be Issued at a Later Date*
- *Section 920* – Mutual Holding Companies – *To Be Issued at a Later Date*
- *Section 930* – Insurance Holding Companies
  - *Appendix 930A* – Industry Background
  - *Appendix 930B* – State Regulation
  - *Appendix 930C* – A. M. Best
- *Section 940 – Large and Complex Enterprises (Conglomerates)*
  - *Appendix 940A – Financial Activities in the European Union*
  - *Appendix 940B – Methods to Assess Capital Adequacy*
  - *Appendix 940C – Prudential Treatment of Minority and Majority Interests in Subsidiaries*

INTRODUCTION

Holding company[1] regulation is an increasingly significant part of our supervision of the thrift industry. At the time of publication, there were 530 holding company enterprises that controlled 543 thrifts. These thrift institutions represented over 50 percent of the industry and controlled over 92 percent of the industry's assets.

A preponderance of thrift holding companies are "shell" organizations that do not engage in any significant activities beyond the ownership of the thrift. However, a substantial number are large businesses or major complexes having more than one holding company along with numerous non-insured subsidiary companies. Companies that currently own thrifts include:

- Securities broker/dealers
- Insurance underwriters and agents
- Manufacturing firms
- Retail companies.

Up until the mid 1990s, the relatively few commercial firms and insurance companies that owned thrifts generally operated these entities independently from the operations in other parts of the organization. Many of these firms looked at their thrift investment as a means of diversifying their operations, not as a critical component of their main business.

During the mid 1990s, however, many financial firms, especially insurance companies and securities firms, determined that it would be in their best interest to offer customers a complete array of proprietary financial products – insurance policies, savings accounts, mortgage loans, credit cards and trust services – all under one roof. Unlike bank holding companies, unitary thrift holding companies could engage in a broad range of activities, including commercial, retail, and financial activities. The passage of the Gramm-Leach-Bliley Act in 1999 restricted commercial firms from owning thrifts; however, existing organizations were grandfathered.[2] The legislation also provided a process by which bank holding companies could elect to become "financial holding companies" that can engage in expanded financial activities, including insurance and securities.

This Handbook outlines our current approach to holding company supervision. This approach is flexible enough to apply to the most complex structures as well as the shell structures, the grandfathered and the nongrandfathered, the low risk as well as the high risk, and the healthy as well as the troubled holding company structures. In other words, this approach allows you to recognize the unique issues presented by any holding company enterprise, meaning the entire corporate structure or "family" associated with the holding company.

More importantly, this Handbook also provides guidance to assess the risks that holding company enterprises pose. It considers the combined risk profile, financial health and stability of the consolidated enterprise, as well as the degree of interdependence between the thrift and its affiliates. Examination conclusions are based on the current and prospective effect holding company enterprises have on their subsidiary insured thrifts.

SUPERVISORY STRATEGY

The Application Process

Prior to organizing or acquiring a thrift, a company is required to undergo a rigorous application process during which OTS intensively scrutinizes its proposed business plan for the insured thrift.

[1] When referring to "holding company" in this Handbook, you should assume it to mean "savings and loan holding company" unless specifically noted otherwise. Similarly, the term "thrift" should be read literally as "savings association."

[2] For more details on the different type of holding companies and activities restrictions, refer to Organizational Structure Section 400.

This rigorous review encompasses the capital structure, managerial expertise and overall integrity of the company. The objective of this process is to ensure that the applicant has the financial and managerial resources to assure the thrift will be operated in a safe and sound manner without jeopardizing the thrift or the deposit insurance funds.[3]

During the application process we address specific concerns we may have with the applicant's proposal. For example:

- If we believe the thrift does not have its own separate corporate identity and may have difficulty operating successfully on a stand-alone basis, we may require the thrift to hire more qualified full-time individuals in key positions, and to perform core business functions within the thrift itself. We seek to strike a balance between allowing holding companies to leverage the synergies of the overall organization and independence on the part of the thrift.
- If the applicant plans to rely on a network of agents or brokers for referral business, we make sure that proper controls are in place and that these representatives will receive comprehensive training.
- If we believe there is a risk that key decision makers working at both the thrift and the holding company could encounter conflicts of interest, we may require the thrift to appoint independent directors.
- If the thrift is heavily reliant on affiliates for funding, we may require the holding company to establish a segregated ear-marked deposit with the thrift, or that the thrift diversify its funding sources.
- If the proposal involves an elevated degree of risk, such as Internet banking or subprime lending, we may require the thrift to hold more capital than the minimum required under our regulations or diversify operations.

[3] Section 500 of the Applications Processing Handbook provides detailed holding company acquisition guidelines. The Applications Processing Handbook is available on the OTS website at www.ots.treas.gov.

Categorizing Holding Company Enterprises

Once the application is approved, and the thrift is formed or acquired, the resulting holding company enterprise is subject to our risk-focused approach to supervision and examination. Based on our analysis of the application, we first assign the holding company enterprise to one of the following two categories:

Category I	Noncomplex or relatively low risk thrift holding company enterprises.
Category II	Complex or higher risk holding company enterprises.

Dividing the holding company population in this manner helps us to more efficiently allocate examination resources, and assists managers in examination scheduling and planning. We expect that Category II holding company enterprises will, in most cases, require a more intense examination.

We will determine the complexity and level of risk by considering all of the following:

- Types of activities and assets of the holding company and its significant affiliates;
- Thrift's dependence on the holding company and other affiliates to perform core functions;
- Thrift's funding method, especially reliance on intercompany borrowings;
- Type and character of intercompany transactions;
- Thrift's significance within the holding company enterprise;
- Financial strength and stability of the holding company; and
- Examination or other supervisory findings at the holding company or subsidiary thrift.

A detailed checklist is contained in the Administrative Program, Section 710 to help determine which category a holding company enterprise should be given. The checklist is used not only at the conclusion of the application analysis, it is also used in preexamination analysis, as more fully explained in Administration Section 200. The category designation directs you to the appropriate holding company examination program.

The Off-site Monitoring Process

Off-site monitoring of the holding company enterprise is conducted between regularly scheduled examinations, and includes a review of reports filed by holding companies. These reports provide detailed information about the structure, activities, management and financial condition of the holding company and its subsidiaries.

In March 2001, we began collecting electronic financial data on holding companies. This data is filed quarterly by the subsidiary thrift along with its Thrift Financial Report. For most holding company enterprises, we have designated one holding company to provide this financial information. In some cases, where more than one distinct ownership path exists, there may be more than one designated filer.[4] Additionally, holding companies file H(b)-11 reports quarterly with the regional office.

Off-site monitoring also relies heavily on private sector information to supplement our own analysis, such as stock analysts' reports and ratings, securities filings, as well as the actual volume and prices of various holding company securities on the public markets. Such information will help identify issues to discuss with management. In addition, in enterprises that have another primary regulator, we will leverage off their information and resources.

Reviewing public reports and key financial data provide us an effective means to identify, and sometimes mitigate, potential problems, without being overly intrusive in the day-to-day operations of the holding company. Communication with management between examinations enhances our supervisory efforts, and keeps us informed of any changes in strategic direction or significant transactions that have the potential to adversely impact the thrift. Section 800 provides an overview of the information collected by OTS. Specific ratios are suggested for monitoring financial trends. By using this information, we are better poised to identify outliers and shifts in trends that will often prompt an informal inquiry.

The On-site Examination Process

On-site holding company examinations are conducted concurrently with the lead insured thrift on a 12 or 18-month cycle, depending on the size and rating of the thrift. The cost of examinations of holding companies, including their other subsidiaries, is assessed against, and paid by, the holding companies. The bill is generally sent to the top-tier[5] holding company, however, you can designate the appropriate company for billing in the Examination Data System (EDS).

The holding company examination focuses on the entire holding company enterprise as opposed to individual registered holding companies. This is the case even if most of your review is devoted to one company within the structure. You must at least consider the organizational structure of the holding company enterprise to determine where the risks lie and where you will devote examination resources. This approach is not meant to imply that you will conduct an in-depth review of every company within the structure. Instead, as noted under the Risk-Focused Approach discussion below, you will determine the scope based on the unique circumstances of each holding company enterprise.

In most cases you will perform one holding company examination, even if multiple tiers of indirect ownership exist. For ease of reference, this examination is electronically stored under the docket number of what is referred to as the "top-

[4] The line items reported on Schedule HC of the Thrift Financial Report and detailed instructions are contained in the Thrift Financial Report Instruction Manual. This manual is available on the OTS website at www.ots.treas.gov.

[5] The top-tier company is the highest level of ownership by a registered holding company.

tier" holding company. Only in situations where the thrift is controlled by more than one holding company that are in distinct ownership paths, may you need to conduct a separate examination for each ownership path.

You will document the examination in a report and assign a composite rating for each examination conducted. In addition, you will assign specific component ratings for complex or higher risk holding company enterprises (Category II).

More specific instructions on these aspects of the holding company examination are contained in Administration Section 200.

RISK-FOCUSED APPROACH

Determining Scope

OTS has the responsibility to identify and control risks that threaten a thrift's safety and soundness. Holding company examinations are risk-focused, meaning that the primary objective is to examine the holding company enterprise in the areas that pose the greatest risk to the thrift subsidiary.

An initial examination scope should target the areas of the holding company/thrift relationship that have higher than normal risk characteristics. A risk-focused philosophy implies that:

- Circumstances will determine the scope of the examination on a case-by-case basis;
- Minimum scope will consist of procedures that are sufficient to assess the significant risks to the subsidiary thrift; and
- Examination procedures will not incorporate every possible aspect of a full-scope examination.

You must ensure that each examination is carefully focused and tailored to the risks posed to the subsidiary thrift by the holding company and other affiliates. This risk-focused approach should enable you to efficiently manage available time and resources. **You are not required to perform every procedure in the holding company examination program**. Instead, you should use judgment to determine the level of review, testing, and analysis necessary to determine the effect of the holding company enterprise on the thrift.

There is no predetermined limit on the examination scope. As additional information indicates a greater degree of risk, the scope may be expanded. For example, the scope of an examination may be expanded if:

- Inadequate, inaccurate, or misleading information is reported in regulatory filings or if filings are frequently revised;
- Numerous affiliate or insider transactions occur between the thrift and its affiliates or insiders, or between the holding company and other affiliates or insiders;
- Substantial changes in holding company management, corporate structure, or ownership occur;
- Substantial changes in operations and financial condition are noted in the holding company enterprise;
- Poor financial condition, inadequate cash flow, or high leverage is found in the holding company enterprise;
- The holding company is perceived to adversely influence the thrift's operations or the thrift's operations are highly integrated with the corporate enterprise;
- The holding company enterprise is adversely affecting the thrift's financial resources through management fees, cash dividends, excessive tax payments, or affiliated transactions;
- The prior holding company or thrift examination revealed other significant concerns that need to be reassessed;
- The current thrift subsidiary examination is raising significant issues related to the holding company enterprise;

- The credit rating of the holding company's debt, if any, is downgraded by a national credit rating service, especially to a noninvestment grade; or
- The stock price of a publicly traded holding company declines substantially more than anticipated relative to a general stock market index.

EXAMINATION COMPONENTS

This Handbook contains detailed guidance and examination procedures for each of the primary areas of review in a holding company examination. There are three generic holding company examination programs, these are:

- Administrative Program, Section 710;
- Abbreviated Holding Company Examination Program; Section 720; and
- CORE Holding Company Examination Program, Section 730.

For all holding company enterprises, you start with the Administrative Program Section 710. This program contains procedures for determining the scope of the examination and the Risk Classification Checklist. You should use the Abbreviated Holding Company Examination Program Section 720 for low risk holding company enterprises (Category I), recognizing that you may need to consult the CORE Holding Company Examination Program Section 730 to address specific areas of risk. You should use the CORE Holding Company Examination Program, Section 730, for all higher risk or complex holding company enterprises (Category II). In addition, there may be specific issues that relate to certain holding company populations contained in Section 900.

The remaining sections of this Handbook are structured to parallel the primary areas of review in a holding company examination. These areas of review also parallel the component rating factors. Component rating factors are assigned for all Category II holding company enterprises, and may be assigned to Category I holding company enterprises at your discretion. Those factors are referred to by the acronym "CORE":

C	Capital
O	Organizational Structure
R	Relationship
E	Earnings

Capital

The first component of a holding company examination is an evaluation of ***Capital***. OTS does not employ a standardized capital requirement that applies to all holding companies. The population of thrift holding companies is far too diverse to develop a single, meaningful capital requirement. Instead, we take a case-by-case approach that considers the overall risk profile of the consolidated entity. This would involve assessing such traditional analytical measures as the overall leverage, the level of short-term debt and liquidity, cash flow and reliance on thrift earnings, interest coverage, quality of earnings, and level of consolidated tangible and equity capital. Our overall objective is to ensure that an appropriate equity buffer exists to shield the thrift from unexpected problems at the parent. Individualized capital requirements can be used as a tool to ratchet the capital level up or down to achieve this goal.

Organizational Structure

The ***Organizational Structure*** section gives an overview of the various types of holding companies. This component of the holding company examination requires you to identify the organizational structure and ownership and assess any changes. Additionally, in this aspect of the holding company examination, you will review the activities of the holding company and other affiliates in the structure to determine not only regulatory permissibility, but also what risks these activities may pose to the thrift.

Relationship

In the ***Relationship*** component, you will assess the interaction of the holding company's board of directors and executive management with the

thrift. In doing this, you will reach conclusions about:

- The materiality of the thrift to the holding company or its controlling shareholders;
- The degree of influence the holding company has over the thrift and how this influence affects the thrift's operations;
- Whether the board of directors provides adequate oversight over the affairs of the holding company and its subsidiaries;
- How actively the holding company is involved in the management of the thrift;
- The degree of interdependence of the thrift and other entities within the holding company structure; and
- Whether the board has implemented effective policies and procedures to ensure that separate corporate identities are maintained and conflicts of interest avoided.

Earnings

In the ***Earnings*** component you will assess the holding company's operations and financial condition and their current and prospective effect on the subsidiary thrift. You will pay close attention to the holding company's earnings trends and capacity as well as cash flow. You will also evaluate the relative contributions and dividend payout ratios of significant subsidiaries of the holding company.

SUMMARY

Examination and supervision of holding companies has become more significant commensurate with the growth in size and diversity of the industry. Our philosophy is to assess the condition of the holding company enterprise and ensure that the thrift is not harmed by the operations of the holding company. We proceed with a risk-focused analysis with the objective of not only determining the current effect of holding company performance on the thrift, but also what the potential future impact might be. Additionally, to make as precise conclusions as possible, our approach is to allocate greater resources to the examinations of holding company enterprises that are complex or otherwise indicate that they possess a higher degree of operating risk.

The following Administration Section 200 details the procedures to be performed to implement this approach along with other examination elements. Other sections of this Handbook provide guidance to help you assess the CORE holding company examination areas.

REFERENCES

United States Code (12 USC)

§ 1467a	Home Owners' Loan Act
§ 1817(j)	Change in Bank Control Act

Code of Federal Regulations (12 CFR)

Part 574	Acquisition of Control of Savings Associations
Part 583	Definitions
Part 584	Regulated Activities

INTRODUCTION

The holding company examination process is much more than the on-site review of records and interaction with holding company representatives. The process begins well before that point and continues after on-site work is completed. The preexamination work is extremely important in categorizing risk and efficiently allocating resources. The actual on-site examination work, which is conducted concurrently with the thrift examination, must be attentive to ongoing findings and reactive so that the scope can be adjusted accordingly. The examination culminates in presenting findings to holding company management and the directorate, completing a professionally prepared report of examination, integrating the findings with the examination of the thrift, and assigning a rating.

Each of these examination phases is integral to the overall process. The combination of off-site monitoring and on-site examinations allows OTS staff to accurately assess the condition of the holding company enterprise and its effect on the insured thrift.

EXAMINATION AUTHORITY

OTS has the authority to conduct examinations of holding companies and their noninsured subsidiaries. This authority is provided by statute (12 USC 1467a(b)(4)) and by regulation (12 CFR 584.1). The authority allows the examination of each registered holding company and each subsidiary as the Director may prescribe. However, as noted in the Supervisory Approach Section 100, the holding company examination is a combined review of the entire enterprise.

There are two exceptions to this broad grant of holding company examination authority. First, if a holding company is a bank holding company that owns both a bank and a thrift, then the Federal Reserve Board regulates the holding company. Secondly, if the holding company has a functionally regulated subsidiary, then we will coordinate our information requests and examinations with the entity's primary regulator. The functional regulation provisions are discussed in greater detail later in this Section. These provisions were enacted to avoid regulatory duplication. In so doing, they specify certain procedural requirements in requesting information and conducting an examination of certain types of entities. Because of this, our examination process must follow certain prescribed steps.

REGULATORY COORDINATION AND COMMUNICATION

Regional Responsibility

The holding company examination is designed to identify the effect, if any, that the holding company enterprise has on the subsidiary thrift. Consequently, regional examination responsibility is normally determined by the geographic location of the thrift rather than the location of the holding company or other affiliates. However, there are some cases where the regions have negotiated alternate arrangements, and regional responsibility will be determined by those negotiations.

There is no question of responsibility for unitary holding companies or for multiple holding companies whose thrifts are located within the same region. Administrative uncertainties arise, however, when a multiple holding company owns thrifts in several regions. A multiple holding company typically owns a "lead" institution. In those few cases where a holding company does not own one thrift that is easily identified as the lead thrift, the affected regions must discuss and cooperatively determine examination responsibility. Further, in the event that it would be more efficient for one region to perform some of the on-site field work on behalf of another region, such an arrangement should be negotiated between the various regions. Communication between regional offices is essential to ensure that there are no conflicts, duplications of effort, or omissions.

Functional Regulation

Communication with other regulators is also essential. You should make every effort to coordinate examination and supervisory efforts with all other interested regulators. This includes banking regulatory agencies (for example, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve, and state banking supervisors), as well as functional regulators of other financial activities.

What Entities Are Functionally Regulated?

With the passage of the Gramm-Leach-Bliley Act, our holding company examination authority was modified to recognize that more than one regulator may be involved in supervising an enterprise that offers a variety of financial products. As part of the examination scoping process, you need to determine whether any entity within the holding company enterprise is "functionally regulated." Functionally regulated entities are:

- Registered broker-dealers. Broker-dealers are regulated by the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers.
- Registered investment advisers with respect to investment advisory and incidental activities. Investment advisers are regulated by the SEC or the state.
- Registered investment companies. Registered investment companies are regulated by the SEC.
- Insurance companies (including agencies) with respect to their insurance and incidental activities. Insurance companies are regulated by the states.
- Entities regulated by the Commodity Futures Trading Commission, with respect to their commodities and incidental activities.

If you identify a subsidiary of the holding company (or the thrift), that is a functionally regulated entity, then you must follow the procedures outlined below. However, it is important to remember that there are no restrictions on examining the holding company itself within the legislation. Therefore, even if a holding company is one of the defined functionally regulated entities, you do not need to follow the exact procedures outlined below. You can examine it since OTS is the primary regulator.

Nonetheless, you should be sensitive to the role of other regulators and strive to coordinate regulatory efforts where practicable.

Keep in mind that even where you are required to follow certain procedural steps, OTS is ultimately responsible for assessing the risks to the insured thrift.

Step 1 – Using Available Information

You can gain information about the affiliate by obtaining and reviewing:

- Reports that are submitted to the primary regulator;
- Information that is otherwise required to be reported publicly; and
- Externally audited financial statements.

This information may be obtained from the affiliate or from other sources. Remember that, since the subsidiary is an investment of the holding company, there is significant information at the parent itself that you may review. The parent should have information to monitor its investment. Thus, the parent should be able to provide you with items such as financial statements, budgets and operating plans, risk management reports, and internal audit reports. Additionally, the parent may have copies of board minutes and even reports prepared for the affiliate's board of directors.

Step 2 – Requesting Information Through the Primary Regulator

If you need further information, then OTS must first request it from the functional regulator. These requests should be coordinated through,

and in consultation with, your regional functional regulation contact. Many of the functional regulators have designated points of contact to facilitate these requests. In addition, OTS has entered into regulatory cooperation and information sharing agreements with many of the functional regulators. These agreements should facilitate communication and the exchange of information between regulators, including the exchange of each agency's respective examination reports. Your functional regulation contact can also help expedite information requests and coordinate examinations.

Step 3 – Requesting Information From the Functionally Regulated Entity

If the functional regulator either does not have the information or fails to provide it, OTS may then request the information directly from the functionally regulated affiliate. However, you may only request information that is necessary to assess:

- A material risk to a thrift or holding company;
- Compliance with a federal law that we have specific authority to enforce against the functionally regulated entity; or
- The systems for monitoring and controlling the financial and operational risks that may threaten the safety and soundness of a thrift.

Again, you should coordinate and consult with your functional regulation contact before making any such request. Your functional regulation contact would have the most day-to-day experience in determining whether the above conditions apply.

You must rely, to the fullest extent possible, on the examination reports and other data supplied by the entity's other regulator. Only by sharing information and working closely with the other state and federal regulators will the legislative goal of reducing duplication be achieved.

Step 4 – When to Pursue an Examination

If you cannot address your concerns with the information made available in the above detailed steps, and you have relied on the examination reports of the primary regulator to the fullest extent possible, then you can examine the entity.[1] After all, if you have concerns after reviewing all the information acquired up to this point, it should be relatively easy to meet one or more of the following criteria required by statute to examine a functionally regulated affiliate:

- You have reasonable cause to believe that the company is engaged in activities that pose a material risk to the insured thrift; or
- After reviewing relevant reports, you reasonably determine that an examination is necessary to inform OTS of the company's systems to monitor and control financial and operational risks that may pose a risk to the safety and soundness of the thrift; or
- Based on reports and other available information, you reasonably believe both of the following circumstances exist:
    1. The affiliate is not in compliance with a federal law that we have specific jurisdiction to enforce, including laws that cover transactions with affiliates; and
    2. We cannot make the determination by examining the thrift or its holding company.

Step 5 – Examination

You should only conduct an on-site examination of a functionally regulated entity for the following purposes:

- To obtain information about the:
    1. Nature of operations and financial condition of the holding company and the functionally regulated entity;
    2. Financial and operational risks within the structure that may threaten the safety and soundness of a thrift (for example, an activity that could impair the thrift due to its materiality); or

[1] OTS may not, however, examine a registered investment company.

3. Systems for monitoring and controlling financial and operational risk.

OR

- To monitor compliance with any Federal law that:
  1. We have specific jurisdiction to enforce against the functionally regulated entity; or
  2. Governs transactions and relationships between a thrift and its functionally regulated subsidiaries.

Whenever possible, you should:

- Coordinate the examination schedule with other agencies;
- Invite interested regulators to examination closing meetings or meetings with the board of directors; and
- Actively participate in meetings with functionally regulated affiliates conducted by other regulatory agencies.

The exchange of information and overall interagency cooperation will facilitate our role of ensuring the safe and sound operation of the thrift.

Foreign-Based Holding Companies

Foreign-based holding companies present the OTS with additional challenges. The geographic location of foreign-based holding companies makes it more difficult to communicate with holding company management. Language and time differences may also exist, thereby complicating communications. In addition, it is often more difficult to accurately assess the financial statements of these companies because they may use different accounting practices. For these reasons, you must pay special attention to foreign-based companies. You may perform the following procedures in addition to those used in examining a domestic based holding company:

- Contact foreign regulators;
- Obtain and review a copy of the foreign rules and regulations applicable to the holding company;
- Obtain and review a copy of the foreign regulator's examination report, if it is a holding company subject to regulation and it is possible to obtain the report;
- Translate foreign currency-based financial reports to U.S. dollars. Use the foreign exchange rate applicable as of the date of the financial reports and the current examination, if possible; and
- Obtain and review a summary of accounting practices and audit standards that apply to the country of the foreign based holding company and determine the effect, if any, on the financial analysis.

PREEXAMINATION ANALYSIS

Because of the need to categorize risk and efficiently allocate resources prior to initiating the on-site examination, the preexamination work is very important. The preexamination analysis is when information should be requested from other regulators to ensure that it is available when the formal examination begins.

Before the examination begins, you must have a sound understanding of the holding company enterprise and the industry(ies) in which it operates in order to accurately complete the scoping process. In many situations, the individual who is responsible for ongoing monitoring may not be the same person who conducts the actual examination. Similarly, the person who conducts the examination may not be familiar with the history and operations of the holding company enterprise.

The Administrative Program, Section 710, identifies several procedures that you should perform during the preexamination work to gain this requisite knowledge. These procedures include reviewing various sources of information that provide insight into the holding company enterprise such as:

- Reports generated by OTS databases;
- Reports submitted to the OTS;
- Reports submitted to other regulators such as the Securities and Exchange Commission (SEC); and
- Prior examination reports, workpapers, and supervisory correspondence.

Once you achieve the requisite understanding of the holding company enterprise, then the process calls for preparing and sending the preexamination response kit (PERK). (A sample PERK is attached as Appendix 200A.) As noted above, you need to determine if any entity in the holding company enterprise is functionally regulated.

Probably one of the most important steps in the preexamination analysis is determining the appropriate risk category for the holding company enterprise. Although most holding company enterprises will already have an assigned category, you need to reassess it based on current information. In the case of a new holding company enterprise, your assessment is important to confirm that the assessment made at the conclusion of the application process is still valid. Your assessment will help you to create a risk-focused scope and allocate examination resources efficiently.

Holding Company Risk Classifications

The Administrative Program contains a Risk Classification Checklist to facilitate this process. It begins by presenting several questions to determine if the enterprise is a low risk shell holding company. If the result is that the holding company is low risk shell (Category I), then there is no need to continue with the checklist. Such a noncomplex entity only requires a minimal examination and you will use the Abbreviated Holding Company Examination Program contained in Section 720 of this Handbook.

If this initial review indicates that the enterprise is more than a shell, there is at least moderate risk. You should then continue with the checklist to assess the nature and degree of these risks. The questions in the program are structured to assist you in assessing the level of risk. The checklist also directs you to specific sections of the CORE Holding Company Examination Program, Section 730, to further evaluate the potential risks that you identify. Once the checklist is completed, you can preliminarily designate the appropriate risk category. Your preliminary assignment may be modified over the course of the examination as you learn more about the holding company enterprise. At the close of the examination, you should update the appropriate risk category classification in the Holding Company Examination Data System.

If the holding company enterprise is a Category I, then the structure is noncomplex and relatively low risk. An examination of this type of entity requires limited resources. You may start with the Abbreviated Program contained in Section 720, but may find that you need to reference more detailed procedures in the full CORE Holding Company Examination Program contained in Section 730. At a minimum, you should conduct those procedures referenced for any item on the Risk Classification Checklist that you answered "yes."

If, however, the holding company enterprise is a Category II, then it is complex or exhibits elements that are higher risk. The examination may require greater resources in order to review the current risks that the entity may pose to the thrift, as well as the prospective risk. You should at least review all procedures of the full CORE Holding Company Examination Program. Use judgment in determining which procedures you actually need to perform.

The following chart summarizes the appropriate program to use:

HC Category	Appropriate Program	Use Judgment
Category I – Low Risk or Noncomplex Holding Company Enterprise	Abbreviated HC Exam Program, Section 720	To determine relevant procedures from full CORE Program, Section 730
Category II – Complex or High Risk Holding Company Enterprise	Full CORE HC Exam Program, Section 730	To determine if all CORE procedures are required.

ON-SITE EXAMINATION

In most cases, the on-site holding company examination will coincide with the examination of the insured thrift subsidiary. And in many cases, management will overlap with various executives holding the same or similar positions at both entities. In such instances, you can coordinate items such as entry and closing meetings with the thrift examination. However, you must ensure that the investigative work for the holding company examination is done interacting with these managers in their capacities as holding company representatives.

In those instances in which management is distinct or there is no concurrent thrift examination, the holding company examination will proceed independently. For the most part, the various protocols and techniques of a thrift examination will be used for the holding company as well. These include protocols of professional behavior and communication techniques such as introductory and closing meetings. Requirements in terms of complete documentation of and support for findings in examination workpapers are also unchanged from the standards for thrift examination reports.

However, holding company examinations may require the exercise of additional procedures that would not be applicable to a thrift examination. For example, a complex holding company structure may have one or more tiers of companies between the thrift and the top tier holding company. Further, there may be large noninsured subsidiaries of the holding company that are significant businesses in their own right.

Holding companies and their noninsured subsidiaries may not be as familiar with regulatory examination practices as their thrift counterparts. Because of this, a cooperative attitude, prompt response to information requests, or accessibility to managers may not be as forthcoming as you are used to seeing in the examination of the thrift. Many such companies, particularly significant subsidiaries with independent managements, may not be aware or fully understand the scope of our authority in regulating the holding company. In the face of such an environment, you must maintain professional conduct and attempt to achieve an understanding on the part of managers of their regulatory responsibilities. You will need to establish working relationships and interact with a variety of personnel.

If difficulties persist, you may need to request that regional supervision become involved in order to influence a more cooperative working relationship.

POSTEXAMINATION PROCEDURES

Once the on-site examination is complete and all outstanding factual issues have been resolved, the communication of these findings must then take place. The principal vehicles for this communication are the closing meeting(s) with holding company representatives and the report of examination.

The Closing Meeting

The closing meeting with holding company representatives is a critical element in the examination process. The meeting may involve directors of the holding company, but will probably be with executive managers. The meeting serves several purposes. It summarizes the examination and advises senior officials what will be included in the report of examination. It also serves to ensure that all issues are clearly understood by all parties and that the issues were either satisfactorily re-

solved during the review or there is unresolved disagreement. If thrift and holding company management overlap, then the presentations for both the holding company and thrift examination may be combined. However, if the findings of either or both examinations are significant, separate presentations may be warranted.

Meetings with the Board of Directors

In certain situations, such as when the holding company presents a recurring material adverse effect on the subsidiary thrift, there is an ongoing significant violation of law or regulation, or the holding company will be rated unsatisfactory, it may be important to conduct a meeting with the holding company's board of directors. The scope of the meeting would include holding company examination findings and conclusions, necessary corrective actions, and, in certain circumstances, discussions concerning possible enforcement remedies. This meeting would generally be conducted after the report of examination is finalized.

The Report of Examination

A final report of examination is then prepared which fully discusses the significant issues found. The report format essentially corresponds to the major examination areas as presented in this Handbook. It also includes background information on the holding company complex as well as information regarding the directorate and executive officers. Various schedules providing financial information may also be presented. A copy of the Holding Company Report of Examination shell is included as Appendix 200B.

Rating the Holding Company Enterprise

An integral component of the examination report is the holding company rating. Once the examination is completed, a composite rating is assigned to the holding company enterprise. The rating becomes part of a valuable management information system from which supervisory personnel can quickly and easily understand the effect that the holding company has on the thrift. Ratings are included in the examination report and disclosed to the holding company.

The composite rating is a consolidation of the various components within the holding company review. These components include the four CORE areas of review that are discussed in detail in separate sections of this Handbook. Rating criteria for each component is included within each section.

For Category II holding company enterprises,[2] these four components are each rated on a scale of one to three in descending order of performance quality. The component ratings encompass the full nature of the enterprise by:

- Evaluating the consolidated **capital** level and composition – **"C"**;
- Observing the **organizational structure** and evaluating the risks of the activities conducted by each entity within the enterprise – **"O"**;
- Assessing how management and the board of directors monitors and oversees the **relationship** with the thrift – **"R"**; and
- Assessing the **earnings** performance and liquidity of the enterprise as a consolidated entity – **"E"**.

This system allows for all aspects of the organization's performance to be considered. Not only are the separate units and businesses assessed for their contribution to the financial strength of the holding company enterprise, but also the condition of the entire organization as one entity is analyzed for its financial soundness. Problems will be noted whether they are isolated or in the whole organization. For example, individual entities may exhibit satisfactory condition but, on a consolidated basis, it becomes evident that inherent risks are not supported by consolidated capital. Conversely, the consolidated whole may appear financially strong with good performance, yet there may be nonbank subsidiaries or even the thrift that exhibit risk, possibly prospective risk, that needs to be reflected in the rating. The resul-

[2] Component ratings may be assigned to Category I holding company enterprises at the examiner's discretion. Only the overall composite rating is mandated for Category I holding company enterprises.

tant composite rating will be a product of this subjective determination process.

Because rating the enterprise is a subjective process, the composite rating is not simply an average of the ratings of the individual components. Your judgment is essential to give the appropriate weighting to the components. The composite rating is based on the following rating definitions:

- **Above Average (A):** Holding company enterprises in this group have a wealth of financial strength. The enterprise could be called upon to provide financial or managerial resources to the thrift if circumstances dictate. Above Average holding company enterprises may exhibit minor weaknesses, but they are deemed to be correctable in the normal course of business. For this rating, all component ratings will generally be rated 1 or 2.
- **Satisfactory (S):** Holding company enterprises in this group are those whose effect on the thrift is considered neutral. Overall, these holding companies exhibit financial conditions and operating performance that pose only a remote threat to the viability of the thrift. Satisfactory holding company enterprises generally do not possess the financial strength to be considered a substantial resource to the thrift. These companies may be reliant on the thrift for dividends or other sources of funds to service debt; however, their debt level and expected need for funds from the thrift are not considered overwhelming. For this rating, the components should generally be rated 2, but may include components rated 1 or 3.
- **Unsatisfactory (U):** This rating is reserved for holding company enterprises that impose a detrimental or burdensome effect on the thrift. Such companies exhibit high levels of various operating weaknesses that at best are considered less than satisfactory. There exists an inordinate reliance involving the thrift. Either the holding company is inordinately reliant on the thrift for cash flow, or the thrift is inordinately reliant on the holding company for critical operating systems. Without immediate corrective action, the thrift's viability may be impaired. Enterprises deserving of this rating will predominantly have components that are rated 3, although even one component with a 3 rating may suffice to justify an overall U rating if the problems are severe enough.

  An Unsatisfactory rating should only be given in the most severe circumstances. Such a rating would be comparable to a 4 or 5 composite thrift rating, and would carry the presumption that formal enforcement action is required, pursuant to RB 18-1b.

Keep in mind that the purpose of rating the holding company, consistent with our risk-focused supervisory approach, is to reflect how the risks and condition of the holding company enterprise affect the thrift. As discussed further below, it is essential to coordinate your findings with the examiners conducting the thrift examination. Since the rating is your assessment of the impact on the thrift, the risks and positive or negative effect of the holding company relationship must be considered in reaching conclusions about the thrift. A holding company that is a drain on thrift resources may negatively impact the thrift's capital rating. Similarly, a holding company that has a wealth of financial or managerial strength may positively impact the thrift's rating. You must also keep in mind that your assessment reflects not only the current financial and operating situation of the holding company enterprise, but also the prospective performance. For example, although a holding company may currently have a neutral effect on the thrift, there may be new businesses or transactions that have the potential of becoming a substantial burden on the thrift.

Integration with Thrift Report of Examination

Since concurrent examinations of the thrift and the holding company will usually be conducted, integration of findings should take place. The examiners-in-charge for both entities should discuss the issues and conclusions. The one responsible for the thrift report should then incorporate the issues into the thrift comments from the perspective of current and potential risks to the thrift from its parent. For example, if the holding company review discloses planned transactions that will require significant cash flow, it may be that these

activities will cause a greater funding need from the thrift. The capital comment in the thrift report should reflect this potential dividend requirement.

Likewise, other thrift examination report areas may be affected. If there is evidence that holding company management is overly influential and subordinating the interests of the thrift to those of the holding company, the thrift report should include a comment. Also a comment may be warranted if the thrift is dependent on the holding company and its affiliates for operational support.

The holding company examination report is the primary medium in which to convey the detailed discussions of issues affecting the holding company enterprise. However, the thrift examination report should capture those issues from the perspective of the effect that the holding company operations may have on the thrift.

SUMMARY

Comprehensive supervision of thrift holding companies is a combination of off-site monitoring and on-site examinations. Off-site monitoring and the preexamination analysis aid in identifying trends, defining the risk classification of the holding company enterprise, and establishing preliminary scope of the examination.

When conducting an examination, you must maintain a professional and cooperative relationship with holding company management and directors, as well as other interested functional regulators.

You must document your findings in a report of examination. The report may recommend appropriate actions to be taken by the holding company or supervisory measures needed in light of the problems identified.

You must assign a composite rating that evaluates the overall effect of the holding company enterprise on the thrift. Component ratings should be assigned for all high risk or complex holding companies (Category II), but are not required for low risk holding companies (Category I). Ratings are included in the examination report and disclosed to the holding company.

You should communicate the examination findings to the directors of the holding company, as well as to other interested regulators. You should recommend follow-up action, as necessary, to address outstanding issues before the next routinely scheduled examination.

To Be Issued At A Later Date

See Attached Document

HOLDING COMPANY
REPORT OF EXAMINATION

March , 2002

holding company
street address
city, state, zip code
Docket Number: Hxxxx

OTS Region:	Region
Type of Examination:	Holding Company
Examination (Start) Date:	08/18/1989
Examination Completion Date:	07/01/1997

Prohibition of Disclosure or Release

This document is the property of the Office of Thrift Supervision. OTS furnishes this document to the holding company for its confidential use. Except as provided in 12 C.F.R. Section 510.5, the holding company, its directors, officers, or employees may not disclose the report, or any portion of it, to unauthorized persons or organizations. Unauthorized persons or organizations include anyone not officially connected with the holding company as an officer, director, employee, attorney, or auditor. The holding company may provide independent auditors access to this report only after the auditors provide a written statement that they will not disclose the report, or any portion of it, to others.

If the holding company receives a subpoena or other legal process calling for production of this document, notify the Regional Director immediately. Advise the attorney and, if necessary, the court of the above prohibition and refer them to 12 C.F.R. Part 510.

Holding Company Structure

Name and Address of Holding Companies	Type of HC	H Number
Holding Company; [List all holding companies within the complex]	Type	H####

Thrift Subsidiaries (Name, City, State)	Region	Docket No.
[Name, City, State]	Identity	#####

Other Affiliates Examined
[Name Only]

Office of Thrift Supervision
Department of the Treasury *Northeast Region*

Office Name • Phone Number • Fax: Click Here and Type Fax Number
Office Address, City, State and Zip
Click Here and Type P.O. Box Address

Click here and type date

holding company
street address
city, state, zip code

Members of the Board or their Representative:

Pursuant to Section 10 of the Home Owners' Loan Act, we performed a risk-focused examination of holding company. The examination began August 18, 1989.

The comments that follow summarize conditions, policies, practices, and trends that affect the subsidiary thrifts' financial condition. We also summarize other major items of concern, not necessarily related to financial condition. All matters of criticism, violations of laws and regulations, and other matters of concern identified within this Report of Examination require the Board of Directors' and management's prompt corrective action.

Information contained in this report is from information filed with the Office of Thrift Supervision and the books and records of the holding company and its subsidiaries. The examiner based the comments and conclusions in this report on an analysis of information obtained from the holding company's records and from other authoritative sources. OTS prepared this report for supervisory purposes and you should not consider it an audit report.

Please review the report in its entirety and note your review. You need not prepare or send OTS a written response to the report.

If you have any questions, please call me at phone number. If I am unavailable, please call name of alternate contact official, title of alternate contact official, at phone number of alternate.

/s/ name
title

Signatures of Directors

We, the undersigned directors of holding company or their representatives, have personally reviewed the contents of the report of examination dated August 18, 1989.

Signature	Date
Click Here and Type Name	
Click Here and Type Name	
Click Here and Type Name	
Click Here and Type Name	
Click Here and Type Name	
Click Here and Type Name	
Click Here and Type Name	
Click Here and Type Name	
Click Here and Type Name	

Note: This form may remain attached to the report of examination and be retained in the institution's file for review during subsequent examinations or may be sent to the OTS Regional Office. The signatures of representatives of the holding company will suffice unless directed otherwise by the OTS.

Table of Contents

OVERVIEW **1**

EXAMINATION CONCLUSIONS AND COMMENTS 1
MATTERS REQUIRING BOARD ATTENTION 2

EXAMINER FINDINGS **3**

BACKGROUND 3
MAJOR AREAS OF REVIEW 3

FINANCIAL AND OTHER DATA **4**

COMPLIANCE WITH ENFORCEMENT ACTIONS 4
DIRECTORS, SENIOR EXECUTIVE OFFICERS, AND ATTORNEYS 5
SUMMARY OF HOLDING COMPANY STOCK OWNERSHIP 6
STATEMENTS OF FINANCIAL CONDITION 7
STATEMENTS OF OPERATIONS 8
RECONCILEMENT OF CONSOLIDATED NET WORTH 9
NET WORTH REQUIREMENT (FOR DIVERSIFIED STATUS) 10
NET EARNINGS REQUIREMENT (FOR DIVERSIFIED STATUS) 11
FINANCIAL REPORTING REQUIREMENTS 12
OUTSTANDING DEBT 13
CASH FLOW STATEMENT 14
VIOLATIONS OF LAWS AND REGULATIONS 16
MISCELLANEOUS 17
OTHER SUBSIDIARY CONSOLIDATED OR UNCONSOLIDATED STATEMENTS 18
HOLDING COMPANY RATING DEFINITIONS 19

Examination Conclusions and Comments

	Current	Previous Examinations	
	08/18/1989	Type Date	Type Date
Holding Company Rating	Type Rating	Type Rating	Type Rating

Click Here and Type

/s/ eic signature
Examiner in Charge

Matters Requiring Board Attention

Due Date	Required Response
Click and Type	* Click and Type
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Examiner Findings

Major Areas of Review

Capital

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Organizational Structure

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Relationship

Click Here and Type

Earnings and Liquidity

Click Here and Type

Compliance with Enforcement Actions

Click Here and Type

Directors, Senior Executive Officers, and Attorneys

Number of Directors Meetings Held During Past 12 Months: Click here and type
Number of Directors Authorized: Click here and type
Number of Vacancies: Click here and type

Name Occupation	Title Year of Birth	No. of Meetings Attended 12 mos.	Tenure as Director Year Appt. Year Exp.	Annual Compensation

Click here and type

Summary of Holding Company Stock Ownership

Stock Ownership	No. of Shares Under Option	No. of Shares Owned	Percent of Total Outstanding
Directors, Officers, Employees, and Affiliated Entities:			
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Total	0	0	0.00%

Others Owning 5% or More of Outstanding Shares			
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Type Here	0	0	0.00%
Total	0	0	0.00%

Total Shares Authorized:	1
Total Shares Outstanding:	100
Par value:	$ 0
Market value (as of Click Here and Type Date):	$ 0

Statements of Financial Condition

Statement of Financial Condition [Consolidated] [Nonconsolidated] (000s)	Fiscal Year Ended mm/dd/yyyy	Fiscal Year Ended mm/dd/yyyy	Fiscal Year Ended mm/dd/yyyy
Assets			
Type Here	$ 0	$ 0	$ 0
Total Assets	$ 0	$ 0	$ 0
Liabilities and Net Worth			
Type Here	$ 0	$ 0	$ 0
Total Liabilities and Net Worth	$ 0	$ 0	$ 0

Statements of Operations

Comparative Statement of Operations [Consolidated] [Nonconsolidated] (000s)	Fiscal Year Ended mm/dd/yyyy	Fiscal Year Ended mm/dd/yyyy	Fiscal Year Ended mm/dd/yyyy
Income			
Type Here	$ 0	$ 0	$ 0
Total Income	$ 0	$ 0	$ 0
Expenses			
Type Here	$ 0	$ 0	$ 0
Total Expenses	$ 0	$ 0	$ 0
Net Income	$ 0	$ 0	$ 0

Reconcilement of Consolidated Net Worth

Net Worth Reconciliation (000s)	Capital Stock	Retained Earnings	Paid-in Surplus	Total Net Worth
Balance at Beginning of Fiscal Year: Date	$ 0	$ 0	$ 0	$ 0
Additions:				
	0	0	0	0
	0	0	0	0
	0	0	0	0
Total Additions	$ 0	$ 0	$ 0	$ 0
Deductions:				
	$ 0	$ 0	$ 0	$ 0
	0	0	0	0
	0	0	0	0
Total Deductions	$ 0	$ 0	$ 0	$ 0
Balance at Close of Fiscal Year: Date	$ 0	$ 0	$ 0	$ 0

Net Worth Requirement (for Diversified Status)

Net Worth Components (000s)		Fiscal Year Ended mm/dd/yyyy
Portion of Holding Company Consolidated Net Worth Represented by:		
Subsidiary Thrifts	$ 0	
Other Related Activities Specified in 12 USC 1467a(c)(2) and 12 C.F.R. 584.2(b)	$ 0	
Total Thrift and Related Activities		$ 0
Consolidated Net Worth as of Close of Fiscal Year		$ 0
Ratio of Total Thrift and Related Activities to Consolidated Net Worth (12 C.F.R. 583.11)		**!Zero Divide**

Net Earnings Requirement (for Diversified Status)

Earnings Components		mm/dd/yyyy (000s)
Net Earnings For Fiscal Year Ended		
Total Net Earnings From Subsidiary Thrifts (included in consolidated net earnings)	$ 0	
Total Net Earnings of Other Related Activities Specified in 12 USC 1467a (c)(2) and 12 C.F.R. 584.2(b) (included in consolidated net earnings)	$ 0	
Total Thrift and Related Activities Earnings		$ 0
Total Consolidated Net Earnings for Fiscal Year		$ 0
Ratio of Total Thrift and Related Activities Earnings to Consolidated Net Earnings (12 C.F.R. 583.11)		**!Zero Divide**

Financial Reporting Requirements

Description	Report Identification	Reporting Period	Dates Filed
Registration Statement	H-(b)10	N/A	Type Here
Annual/Current Report	H-(b)11	Fiscal Year/Qtr Ending	Type Here
Activities Application/Notice	N/A	Since Preceding Exam	Type Here
Capital Distribution Application/Notification	N/A	Since Preceding Exam	Type Here
Other Filings or Comments			

Outstanding Debt

Name of Lender Maturity Date Date of Borrowing Original Amount	Amount Outstanding	Type of Security	Purpose	Interest Rate
Click Here and Type				

Cash Flow Statement

Cash Flow Analysis (000s)	FY Ended mm/dd/yyyy	FY Ended mm/dd/yyyy
Internal Funding Sources		
Income		
Dividends from subsidiaries	$ 0	$ 0
Interest from subsidiaries	0	0
Management and service fees	0	0
Other operating cash income	0	0
Total Operating Cash Income	$ 0	$ 0
Expenses		
Interest Paid	$ 0	$ 0
Lease and rental	0	0
Salary and employee benefits	0	0
Other operating cash expenses	0	0
Total Operating Cash Expenses	$ 0	$ 0
Before Tax Cash Income	$ 0	$ 0
Taxes		
Income tax payments from:		
Thrifts	$ 0	$ 0
Other Affiliates	0	0
Less: Income tax payments	0	0
Net Income Tax	$ 0	$ 0
After-Tax Cash Income	$ 0	$ 0

Cash Flow Statement (continued)

Cash Flow Analysis (000s)	FY Ended mm/dd/yyyy	FY Ended mm/dd/yyyy
External Sources		
Issuance of stock	$ 0	$ 0
Net increase in borrowed funds	0	0
Advances to subsidiaries repaid:		
Thrifts	0	0
Other Affiliates	0	0
Sale of assets	0	0
Total External Sources	$ 0	$ 0
External Uses		
Net decrease in borrowed funds	$ 0	$ 0
Dividend payments:	0	0
Equity investment in subsidiaries		
Thrifts	0	0
Other Affiliates	0	0
Advances to subsidiaries:		
Thrifts	0	0
Other Affiliates	0	0
Purchase of assets	0	0
Total External Uses	$ 0	$ 0
Net External Position (External Sources less External Uses)	$ 0	$ 0
Net Change In Cash Position	$ 0	$ 0
(After-tax cash income plus net external cash position)		
Cash Balance Beginning	$ 0	$ 0
Cash Balance Ending	$ 0	$ 0

Violations of Laws and Regulations

Regulation	# Occurrences	Amount of Loss

Click Here and Insert Reg Cite
Click Here and Type Comments

Miscellaneous

Click Here and Type

Other Subsidiary Consolidated or Unconsolidated Statements

Click Here and Type

Holding Company Rating Definitions

Upon completion of the examination, the holding company complex is rated by the regulator. The holding company rating reflects the overall effect of holding companies and their subsidiaries on the savings association, rather than the condition of the holding company itself.

The three holding company ratings are defined as follows:

Above Average

Holding company enterprises in this group have a wealth of financial strength. The enterprise could be called upon to provide financial or managerial resources to the thrift if circumstances dictate. Above Average holding company enterprises may exhibit minor weaknesses, but they are deemed to be correctable in the normal course of business. For this rating, all component ratings will generally be rated 1 or 2.

Satisfactory

Holding company enterprises in this group are those whose effect on the thrift is considered neutral. Overall, these holding companies exhibit financial conditions and operating performance that pose only a remote threat to the viability of the thrift. Satisfactory holding company enterprises generally do not possess the financial strength to be considered a substantial resource to the thrift. These companies may be reliant on the thrift for dividends or other sources of funds to service debt, however, their debt level and expected funds from the thrift are not considered overwhelming. For this rating, the components should generally be rated 2, but may include 1 or 3 rated components.

Unsatisfactory

This rating is reserved for holding company enterprises that impose a detrimental or burdensome effect on the thrift. Such companies exhibit high levels of various operating weaknesses that at best are considered less than satisfactory. There is an actual or probably inordinate reliance on the insured subsidiary for assistance. Without immediate corrective action, viability may be impaired. Enterprises deserving this rating will predominantly have 3 rated components.

INTRODUCTION

Capital serves many purposes, and the level and composition of capital held by a company is an important measure of the company's overall financial health, as well as the health of its subsidiaries. Capital provides a holding company with a buffer in times of poor operating performance, can help maintain public confidence in the holding company, and supports reasonable growth.

The OTS does not impose either consolidated or unconsolidated regulatory capital requirements on thrift holding companies. Although there is no specific numerical requirement (ratio), OTS-regulated holding companies should have a prudential level of capital to support their risk profile. The lack of any specific capital requirement means that you have to consider all aspects of an organization's risk profile to determine if capital is adequate on a case-by-case basis. Your conclusions about the capital structure of a holding company will depend upon findings you make in other components of the holding company examination, including earnings, relationship, and the level of risk inherent in the holding company's activities.

The purpose of this Section is to assist you in evaluating capital at the holding company level and in evaluating its potential effect on the subsidiary thrift. In reaching your conclusions, you should take advantage of publicly available information, including industry analyst reports and ratings, as well as indicators of market trends and perceptions. You should also use peer analysis to compare the level of capital held by other companies engaged in similar lines of business.[1]

[1] Unless otherwise noted, you should assume all asset, debt and capital calculations in this section are based on Generally Accepted Accounting Principles (GAAP), which means all such figures will be calculated on a consolidated basis.

CAPITAL SUFFICIENCY/RISK ANALYSIS

High capital ratios are not necessarily indicative of overall capital sufficiency, especially when an organization is involved in risky activities or securitizations and other capital arbitrage techniques. The scope and complexity of today's banking business, particularly with respect to offering an expanded array of financial products, makes it even more important to evaluate capital based on a company's overall risk profile. Because thrift holding companies are so diverse, the adequacy of capital cannot be determined solely on the basis of a numeric formula or standard. Instead, capital management must be a dynamic process. Holding companies must ensure that they have sufficient capital to support their underlying risks.

Organizations are increasingly using internal processes to assess risks and to ensure that capital, liquidity, and other financial resources are sufficient in relation to an organization's overall risk profile. The sophistication and level of detail of a holding company's capital management techniques will vary based on the complexity and size of the enterprise. You should request the holding company's support and analysis for its capital management strategies as part of your preexamination response kit or during the course of the examination.

Assessing the Overall Risk Profile

The need to assess overall risk is inherent in each component of the holding company examination. This process starts by completing the Risk Classification Checklist in the Administrative Program, Section 710.

This preliminary risk assessment is then refined and updated as a better understanding of the holding company is gleaned during the course of the examination.

You will find that many of the conclusions that you will need to make in addressing the capital

strength of a holding company will be dependent on findings made in other sections of the examination process. For example, the following questions will help you assess the overall risk profile of a holding company's capital structure. In many cases, you will need to review other sections of this handbook in order to properly address them:

Issues Addressed in the Organizational Structure Section

- How significant is the thrift in the holding company structure?
- What risks do the holding company activities and assets present?

Issues Addressed in the Relationship Section

- Has the holding company influenced the thrift to engage in riskier activities and if so, how?
- What is the direct or indirect impact of intercompany transactions and transactions with insiders (for example, loans, asset purchases or sales, guarantees, and service agreements)?
- What is the quality of management and risk management systems?

Issue Addressed in the Earnings Section

- Is the overall financial condition of the holding company deteriorating, stable, or improving?

Other Capital Related Issues

- Does the holding company or other affiliates have off-balance sheet contracts or activities (with explicit or implied recourse) that result in a higher degree of risk exposure than is apparent from its balance sheet?
- Are there any terms, conditions or covenants in the holding company's or other affiliate's securitization documents that could adversely impact the thrift, such as a supervisory action that could trigger early amortization or the transfer of servicing?
- How does the amount of capital held by the holding company compare to its peers?
- What significant risks does the thrift face?

In the normal course of business, companies encounter several types of risks. ***The following are examples*** *of how various types of risk can be present in a holding company enterprise and can adversely impact capital.*

Credit Risk – The risk that a counterparty will fail to perform.

A holding company has pronounced credit risk on a corporate-wide basis evidenced by a high volume of residuals and subordinate securities held at the parent, and subprime lending and securitization activities conducted by subsidiaries. Residual and subordinate holdings total more than half of capital. Further, management has been slow to incorporate actual default and prepayment data in valuing subordinate securities. Consequently, those asset values are overstated, as is reported capital. Thus, although this holding company boasts a capital ratio that would equate to "well capitalized," its capital level is insufficient.

Market Risk – This includes a wide range of scenarios and unexpected events resulting from adverse movements in market rates or prices. Such events may lead the holding company to influence the thrift to engage in riskier activities.

A holding company decides to quickly expand its business. Without a proportionate increase in capital, the holding company has lost flexibility, and is unable to react to adverse market conditions. Not only does this affect the holding company's ability to support the thrift, the holding company may pressure the thrift for additional financial resources and encourage the thrift to assume a higher risk profile to attempt to maximize returns.

Funding and Liquidity Risk - The risk that the entity will be unable to meet its payment obligations on settlement dates.

A holding company has massive debt service requirements due to a number of acquisitions. Its heavy reliance on borrowed funds, coupled with inadequate operating policies and procedures, have led to undue pressure at the thrift level to dividend funds to the parent for debt service.

A holding company's funding strategy should support maturing liabilities with liquid assets and avoid the over reliance on any single or volatile source of funds. Holding companies and their affiliates must maintain sufficient liquidity and capital to service outstanding debt obligations without adversely affecting the thrift.

Operational Risk - The risk that deficiencies in information systems or internal controls will result in unexpected loss. Such deficiencies generally are a function of the quality of management and information systems.

A holding company's poor capital management results from, among other things, inaccurate and misleading financial reporting, failure to implement corrective actions from the last exam, internal audit deficiencies, and the lack of corporate separateness. Although the quantitative measure of holding company capital appears high, poor reporting provides no comfort in the quality and accuracy of that number.

Interdependency of Systems and Operations Risk – The risk that the activities/operations of the holding company are so intermingled with the thrift that the cessation of a holding company operation negatively impacts the thrift.

A holding company is a mortgage banker that does securitizations, with the thrift providing the servicing. The servicing income represents a major component of the thrift's revenue. The holding company sells the mortgage banking operation. The sale has a detrimental effect on the thrift due to its reliance on the mortgage banking operation to provide a continuing source of servicing income to cover its operating expenses.

Higher Risk Holding Company Activities – The risk that the holding company will make investments or engage in activities, especially with respect to activities that the thrift itself cannot engage, that pose risk to the thrift or that could jeopardize the thrift's reputation.

A holding company forms a subsidiary to foreclose on a large real estate development project. The project is only partially complete, major capital expenditures are anticipated, and, although the holding company has a reasonable capital level, the debt service and operating expense requirements are substantial. The holding company's financial condition deteriorates to a point where it can no longer service the debt, and, as a result, pressures the thrift for additional dividends in order to fund the completion of the project. Later, the holding company attempts to convince the thrift to buy a portion of the REO, which is impermissible.

Legal Risk – The risk that contracts are not legally enforceable or properly documented.

A thrift has a note receivable from its holding company that is not properly recorded. No board minutes or journal entries have recorded the transaction. This is largely due to the fact that accounting and treasury personnel don't enforce corporate separateness of the holding company and the thrift. In actuality, this note does not legally exist, which means the thrift is overstating its capital by counting this nonexistent asset. Once the asset is written off, the capital of the thrift is below its regulatory requirement

EVALUATING CAPITAL ON A CASE-BY-CASE BASIS

OTS' approach to holding company supervision provides for the evaluation of capital on a case-by-case basis, considering the overall risk profile of each holding company enterprise. To do this, you will need to consider the following basic financial elements:

- **Debt** – the ratio of holding company debt as a percentage of tangible capital[2], the effect holding company debt has on the thrift, and the ability of the holding company to service debt or fulfill holding company obligations.
- **Quality and Availability of Capital** – the ratio of total capital to total assets and the ratio of tangible capital at the holding company as a percentage of tangible assets[3], the quality of that capital, and the ability of the holding company to raise new capital.
- **Dividends** – the ratio of the holding company's earnings being paid out in dividends, and whether the quality and level of holding company earnings is sufficient to support such dividends.

Debt

Financial leverage is the use of debt[4] to supplement the equity in a company's capital and funding structure. From the perspective of management and stockholders, debt can represent a favorable financial tool as the owners only need to provide a small portion of the total financing, and much of the financial risk will be borne by lenders. This allows the existing owners to maintain control with a limited investment at stake and, assuming the proceeds are reinvested at a positive spread, the earnings generated will increase the overall Return on Equity (ROE). Some companies use debt for the acquisition of other entities.

Although the judicious use of leverage is a favorable financial management technique, you should be alert to the following pitfalls:

- Leverage may pressure management to produce short-term revenues to service debt, and may result in greater risk taking.
- Firms with high levels of leverage are more susceptible to losses during periods of economic downturn, either in the economy at large or the specific industries in which they do business. This can have a compounding effect as the economic downturn may result in a declining financial condition, which in turn increases borrowing costs as debt matures and must be renewed, often at higher interest rates.
- The use of leverage reduces management's flexibility in making future decisions; lenders may impose the following types of debt covenants that could adversely impact the thrift:
  - Limits on future debt issues;
  - Provisions to accelerate repayment of the debt in the event certain covenants are violated;
  - Limits on dividend payments; or
  - Specific constraints on operating ratios.

You must assess both the role of leverage within the consolidated holding company operations/financial structure and the actual, and potential, impact such leverage may have on the operations of the thrift. Implicit in such analysis is the need to identify the extent to which the holding company utilizes debt to capitalize/fund the thrift's operations, and the degree to which the parent relies upon the thrift to provide cash flow for debt service.

Recently, debt or debt-like instruments such as trust preferred securities can be issued at such attractive rates that management feels compelled to raise such funds before having a clear idea of what to do with the proceeds. Holding company boards of directors are expected to develop prudent capital management plans prior to undertaking financing activities in the marketplace. Otherwise, they may be implementing a funding strategy that may place undue financial burdens on the thrift's operations. You should review the way the proceeds of such financings are deployed, and how such obligations are serviced. You will also need to determine whether

[2] Tangible Capital = Capital minus intangible assets.

[3] Tangible assets = Total assets minus intangible assets.

[4] Debt includes borrowings with specific terms and excludes deposits and transactional liabilities.

the holding company is, in general, overextended given its financial characteristics.

You should generally consider the following questions:

- What is the ratio of holding company debt as a percentage of tangible capital?[5]
- Is the level of debt rising?
- What investments or activities does the debt fund?
- Could the terms, conditions, or covenants of the debt have an adverse effect on the thrift?
- What is the maturity schedule for debt instruments' effect on liquidity?
- What is the level of interest expense?
- Is interest expense a significant percentage of recurring income?
- What debt ratings has the holding company received from nationally recognized credit organizations?

There are several ratios that you may use to assess these factors.

Calculate the parent company leverage by looking at the debt to capital ratio:

$$\underline{\textit{Debt to Capital Ratio}} = \frac{\text{Long-Term Debt}}{\text{Tangible Capital}}$$

A holding company with a low debt to capital ratio will generally have greater access to the capital markets.

There are no "bright line" thresholds for categorizing highly leveraged operations and it is primarily the company's earnings power that dictates the acceptable level of debt. Accordingly, the focus of your review should be on the ability of the company to generate cash flow to meet its fixed debt service. However, as a general guideline, you should become increasingly vigilant as debt to capital ratios start to trend past 50 percent. It is presumed that a debt ratio significantly exceeding 50 percent will trigger intensive analysis of holding company cash flow needs and earnings power, and an appropriate comment in the holding company report of examination is most likely warranted. Regardless, you should be sensitive to long and short-term trends and management's future plans for using leverage.

Also, compute the total debt to equity ratio on a market value basis.

$$\underline{\textit{Total Debt to Equity Ratio at Market Value}} = \frac{\text{Total Debt at Book Value}}{\text{Equity at Market Value}}$$

If the market value of equity is higher than the book value, the above ratio will be lower than the debt to equity ratio on a book value basis. This indicates a favorable market perception and the ability to raise capital at an attractive price. However, if the market value of equity is lower than the book value, the above ratio will exceed the ratio on a book value basis, indicating the market will only provide capital at a discount to book value.

Note: For holding companies with significant nonthrift operations, a more meaningful calculation might be the ratio of Debt to Total Assets. This would be especially true for holding companies involved in industries with a high percentage of fixed assets. (Such debt should be long-term to match the maturity of the assets acquired.) Follow-up may be required for ratios in excess of ten percent, but ratios should be compared to appropriate peers. For comparisons, utilize Robert Morris Associates (RMA) financial statement analysis.

Another important step in analyzing parent company leverage is calculating the leverage ratio:

[5] You should also include trust preferred securities, or similar hybrid instruments that possess both debt and equity characteristics, when assessing the holding company's overall use of leverage.

Leverage Ratio =

$$\frac{\text{Long-Term Debt}}{\text{Long-Term Debt plus Capital}}$$

The lower the ratio, the less exposure to loss when the company's performance is poor, but also a lower return on equity when performance is good.

The proceeds of parent company long-term debt may be advanced to the thrift either as debt or equity. The condition referred to as simple leverage exists when holding company debt proceeds are advanced to the subsidiary thrift as debt. Such debt should have repayment terms matching those imposed upon the holding company by its lender and should be serviced from the thrift's current earnings. The condition referred to as double leverage exists when funds obtained by the holding company from debt proceeds are invested into the thrift subsidiary as equity. Increasing the capital base of the thrift allows the thrift to increase its borrowings as well, thereby compounding the original holding company debt and resulting in higher consolidated leverage. In this situation, thrift revenues must be sufficient to service both levels of debt because typically the parent will rely upon dividends from the thrift subsidiary to fund its debt service requirements. [6] Such situations can generate substantial pressure on the thrift to maintain its earnings to support future dividend payments, thereby increasing the temptation for the thrift to engage in higher risk operations.

Within complex operations, double leverage will not always be readily evident, as parent level debt may not be directly allocated to provide equity in the thrift. One general measure that you can use as a proxy to help identify the role of double leverage is the following ratio:

$$\frac{\text{Thrift \$ Equity}}{\text{Holding Company \$ Equity}}$$

Higher ratios, or a trend of increasing ratios, could indicate the existence or growth of double leverage in the holding company/thrift relationship. A ratio of 100% indicates that there is no double leverage in the organization, while a ratio of 125% indicates that 25% of the thrift's equity capital was derived from sources other than parent equity investments into the subsidiary or through subsidiary retained earnings.

Another situation you must watch for is when nonthrift subsidiaries of highly leveraged holding companies experience operating problems. Even when holding company debt is not advanced to the thrift, the parent may look to the thrift to be the primary or sole source of debt service cash flow due to weaknesses elsewhere in its organization. This too could result in the parent imposing a more aggressive or high risk operating philosophy upon the thrift to generate near term earnings to support higher dividends, management fees, or tax sharing payments.

If you determine that any further leveraging of the holding company poses a risk to the thrift, you must immediately advise the Regional Director. The Regional Director may deem it appropriate to require the holding company to provide specific information on its capital planning and allocation process or notice before incurring, renewing or rolling over any debt or hybrid securities with debt-like characteristics. Such action may be most appropriate for holding companies:

- Whose subsidiary thrift institution has a composite CAMELS rating of 3, 4 or 5;
- That are rated unsatisfactory; or
- That would be of supervisory concern if additional debt were issued.

Quality and Availability of Capital

Capital provides a secondary source of financial protection for the holding company if operating capacity proves insufficient. A holding company that has capital does not necessarily have sufficient cash flow to meet contractual obligations when they are due. Capital can provide cash only if selected assets can be sold, the capital is used to

[6] Capital distributions must be within the limits prescribed by 12 CFR 563, Subpart E (563.140 – 563.146).

secure new debt, or new equity can be issued. In addition, a particular capital position can also be a function of a company's accounting practices, and, thus, should not be solely viewed as a proxy of a company's financial health. Accounting standards are often assumption driven and aggressive accounting assumptions can overstate the value of assets and thus cloud a company's true capital position.

Before any relevant quantitative capital measures can be calculated, you must determine the GAAP capital of the holding company. GAAP capital represents the aggregate of holding company capital, including the capital of all subsidiaries, after the elimination of all intercompany items. Capital must be computed in accordance with GAAP, or some other approved regulatory accounting for functionally regulated affiliates. For affiliates that are regulated by another state or federal agency, determine if there are any agreements or conditions imposed that would require the holding company to devote financial resources (including capital contributions) to that entity. If such agreements or conditions exist, determine the extent to which they could ultimately have an adverse effect on the subsidiary thrift.

Once you determine the amount of GAAP capital, you must consider qualitative as well as quantitative factors. To determine the adequacy of a holding company's capital, you should answer the following questions:

- What is the ratio of total capital to total assets?
- What is the ratio of tangible capital to tangible assets?
- To what extent does the holding company rely on trust preferred securities or other hybrid equity securities as a source of financing? You should closely scrutinize any holding company that has trust preferred securities, or similar instruments with both debt and equity characteristics, that approach 25 percent of the holding company's tangible capital.
- Does the holding company have a high proportion of assets that a thrift would be unable to count as capital?
- Does the holding company have the ability to raise new equity capital or generate capital internally, through earnings other than from the thrift?
- Has the holding company's capital position deteriorated since the last examination, and if so, why?
- Have significant asset/liability restructurings, acquisitions, or divestitures occurred that might negatively affect the financial or managerial relationship between the thrift and the holding company?

As you review capital, keep in mind that there are some positive factors that enhance capital protection. These include:

- Strong management that has a record of superior capital management;
- Sound asset quality; and
- A history of strong (recurring) and consistent (stable) operating earnings and cash flow.

Similarly, potential adverse factors that detract from the holding company's capital condition include:

- Demonstrably weak or ineffective management;
- Low liquidity, high interest rate risk exposure, or high foreign exchange exposure;
- Significant levels of off-balance sheet activities, including asset securitization activities, which can result in the retention of substantial recourse;
- Reliance on wholesale and short-term funding sources, or a significant amount of longer-term debt that will mature soon;
- Engaging in activities viewed as being high risk, unless adequately hedged and well-managed;

- Internal inability to generate sufficient capital because asset growth exceeds sustainable equity capital formation;
- No, or limited, access to capital markets; and
- Excessive capital distributions paid to, or the divestiture of subsidiaries to, stockholders.

One analytical approach that you should consider is how the holding company's capital position would look if it were a thrift or a bank holding company. This approach becomes less helpful if the holding company is predominately a commercial company, which has a much different balance sheet than financial companies. Nevertheless, such an analysis can lead to important findings.

For instance, the presence of assets at the holding company level that could not be counted as capital at the thrift level would lead to questions about the quality of the holding company's capital. Even though the thrift may be better off if such assets are not at the thrift level, the presence of the assets on the consolidated balance sheet will still affect the health of the overall holding company enterprise.

The following are some examples of the types of assets that either could not be counted as thrift capital, or have limitations as to how much could be counted as thrift capital:

- Direct investments in real estate ventures.
- Hybrid instruments that possess debt characteristics, like trust preferred securities.
- A high ratio of assets, such as IO strip securities, to capital, in which a thrift would have to hold dollar-for-dollar capital.

Similarly, assets that are not considered tangible under GAAP may, nonetheless, produce revenues or otherwise have creditable value. Such assets might include, for example, assets (such as mortgage servicing rights) that the thrift may include in computing core and tangible capital.[7] You should factor such assets into your assessment of whether capital is sufficient.

Another approach you may wish to consider is to regard the holding company as a new applicant for a savings and loan charter. Given its current financial condition, and types of activities, would you feel comfortable approving this company as a savings and loan holding company?

Dividends

The dividend practices of the holding company may affect the financial position of its thrift and other subsidiaries. Dividend policy influences the sustainable growth rate of any organization based on its effect on retained internal capital.

If the level of a holding company's dividends poses an actual or potential burden on the thrift subsidiary, then you should determine if the holding company's dividend payout and prospective rate of earnings retention are consistent with its capital needs, asset quality, growth, cash flow, and overall financial condition. You may conclude that it is necessary to calculate the dividend payout ratios for the parent and all holding company subsidiaries using the following formula.

Dividend Payout Ratio =

$$\frac{\text{Dividends Paid}}{\text{Net Income}}$$

The holding company's dividend payout ratio should be reasonable and consistent with any existing business plan. You should compare the dividend payout ratio, net income, and asset growth of each significant affiliate of the holding company.

In general, the following statements apply to holding company dividends:

- Sustainable core earnings should suffice to pay the dividend over the long term.
- There should be adequate liquid assets on hand to make dividend payments.

[7] See 12 CFR 567.12.

- Generally, a holding company and its thrift should avoid borrowing funds to provide for the payment of dividends to shareholders of the holding company. (Such an action may be proposed in certain situations when management prefers not to cut the dividend to avoid a negative market reaction. Similarly, borrowing may be needed if the company's cash flows are predominantly achieved seasonally, such as a retailer heavily dependent on holiday sales.)
- Neither the holding company nor the thrift should have to sell assets to provide funds for the payment of dividends to the holding company's shareholders.

The inability to sustain or increase stockholders' dividends may demonstrate holding company weaknesses. Often times, the suspension of dividends is the result of the holding company facing a liquidity squeeze. Even the perception of the holding company running low on cash can lead to repercussions for the subsidiary thrift. When the thrift's public identity is linked to the holding company with a similar name, a crisis or loss of confidence in the holding company could adversely effect the thrift regardless of the thrift's own financial stability. For example, for members of the public not familiar with the distinction between the thrift and its parent, a run on the thrift may result from the perception that its holding company is running out of cash. To avoid loss of market confidence, a thrift may enter into a questionable transaction with its holding company or affiliate in an attempt to avoid a crisis.

CAPITAL MANAGEMENT AND OVERSIGHT

As noted above, one of the positive qualitative factors affecting the adequacy of capital is strong capital management. Managers and directors should attempt to anticipate capital needs and provide for the maintenance of adequate capitalization. Good practice dictates that holding company management should develop a capital management plan if the holding company's ratios are low relative to others with similar risk profiles in their industry, or are likely to fluctuate. A good plan sets forth specific strategies by which management intends to reach its established goals.

Most financial organizations consider several factors in evaluating their overall capital adequacy. These include:

- Comparing their own capital ratios with industry peers;
- Risk concentrations in credit and other activities;
- Current and desired credit-agency ratings; and
- Historical experiences, including severe adverse events in its past.

You may also want to consider these factors as you analyze capital.

Many holding companies and other financial organizations use stress testing, and scenario analysis, as a tool to estimate unexpected losses. This process helps organizations project the performance of their assets under conservative "stress test" scenarios. Stress testing can estimate the portfolio exposure to deteriorating economic, market and business conditions. It also allows for different assumptions to be input, thereby allowing management to foresee potential consequences.

Holding companies should be able to demonstrate that their approach to relating capital to risk is sound. One method for a holding company to determine if it holds a sufficient amount of capital is if it meets an objective measure of financial health, such as a target public-agency debt rating or even a statistically measured maximum probability of becoming insolvent over a given time horizon. This latter method is the foundation of the Basle Accord's treatment of capital requirements for market and foreign-exchange risk. Risk assessment must address all relevant risks, including, but not limited to: credit risk, market risk, liquidity risk, interest rate risk, operational risks, and legal risk.

Holding companies without adequate procedures to estimate and document the level of capital nec-

essary to support their activities should be criticized.

You should interview holding company management to identify their plans for ensuring a safe cushion of capital. Specifically, you should inquire whether they have plans for:

- New debt issues or sales of equity;
- Additional capital contributions;
- Loans, transfers, or distributions of holding company assets within the holding company structure; or
- Acquisitions.

During your conversations, you also should emphasize that the holding company's level of capital is a major consideration in the overall examination rating.

RATING THE CAPITAL COMPONENT

To properly assess risk at the holding company, you must consider the thrift subsidiary, the nonbank subsidiaries, the parent only and the consolidated entity. You should consider capital on a consolidated basis as holding company management has some discretion as to the allocation of capital within the organization. In some situations it may also be useful to consider capital after deducting thrift capital. For holding companies with functionally regulated subsidiaries, you should also analyze capital after deducting capital held within such functionally regulated subsidiaries.

Evaluate capital sufficiency, on a case-by-case basis, considering among other things, the holding company's own documented analysis of the capital needed to support its activities. You should expect capital levels to be risk sensitive.

Further, you need to remember that all the holding company examination components are integral to the overall examination process. For example, your findings about earnings will clearly have an impact on your final conclusions about capital adequacy.

You should assign a ***capital component of "1"*** if the holding company serves as a financial resource to the entire corporation. Such companies provide both a basis for growth and access to capital markets as needed.

You should assign a ***capital component rating of "2"*** if the holding company can support the volume and risk of its activities, as well as the activities of its subsidiaries. Such holding companies are also positioned to provide a cushion for unexpected losses, and support its level of borrowing, as well as that of its subsidiaries.

You should assign a ***capital component rating of "3"*** to any holding company that does not have sufficient capital to serve as a buffer for its own activities and activities of its other subsidiaries. Such companies present the risk of adverse effects on the thrift.

SUMMARY

The capital sufficiency of a holding company is a critical factor in the regulation of thrift holding companies. Your analysis should consider both the quantity and quality of capital and the effect that the holding company's operations may have on the thrift currently, and in the future. To do this properly, you must consider the:

- Capital needed based on the risk associated with each holding company and nonbank subsidiary activity;
- Relationship between debt and capital;
- Existence of long-term debt in the capital structure;
- Extent and use of debt at the parent to fund capital investments of subsidiaries;
- Trend of capital in comparison to peer groups;

- Management's ability to devise capital plans in the event of a capital deficiency or planned expansion;
- Ability to access the capital markets;
- Extent of concentration in any one asset or type of asset, including intangibles, interest only (I/O) strips, illiquid assets, deferred tax assets, and
- Extent of off-balance sheet exposure.

INTRODUCTION

This Section highlights the various ways that holding company enterprises may be structured, and the importance of reviewing and understanding each structure. This Section will also provide an overview of control thresholds to help you determine if there have been changes in the ownership structure, and, if so, what regulatory processes apply. Finally, the framework for determining what activities a holding company may engage in is outlined. As you will see, there is a correlation between how a holding company is structured and the activities in which it may engage.

Once you understand the holding company enterprise and its activities, you must then evaluate what risks, if any, may affect the subsidiary thrift. You must determine whether there are elements of the holding company structure, or business interests of the holding company enterprise, that hold potential risks for the thrift. This means considering not only the activities of the holding company and other affiliates, but also activities of the thrift itself.

You must ensure that the thrift is not being used as a dumping ground for low-quality or high-risk assets, or a vehicle for conducting risky activities. Furthermore, you must consider the materiality of the thrift to the holding company enterprise and its controlling shareholders. If the thrift is immaterial to the overall holdings of the holding company or controlling shareholders, there may be less incentive for them to ensure its safe and sound operation or to provide financial support if needed. On the other hand, regardless of materiality, the holding company may not want to risk tarnishing its reputation and, therefore, do whatever is necessary to safeguard the thrift. This same strategy may extend to an uninsured affiliate that is in trouble. To protect its reputation, the holding company may divert thrift resources to the troubled affiliate.

Every holding company enterprise is uniquely structured and managed. Each presents different risks and issues. These risks change not only from enterprise to enterprise, but over time within a given holding company enterprise. Keep in mind that as you assess the organizational structure, you must consider not only the current risks that may be evident, but also prospective risks.

STRUCTURE

A savings and loan holding company is any company that directly or indirectly controls a savings association. This ownership interest can result in several forms of organization. In their most basic form, holding companies are either ***unitary*** or ***multiple***. For the most part, these designations are self-explanatory:

- A ***unitary*** holding company controls one thrift.
- A ***multiple*** holding company controls more than one thrift.

The vast majority of thrift holding companies are unitary.

Many times a holding company is simply a shell corporation established for the sole purpose of owning a thrift. Shell holding companies have the following characteristics:

- Low or insignificant amounts of debt;
- Minimal activities, other than holding the stock in the thrift; and
- Low risk, highly liquid investments.

Thrift holding companies are also designated as ***diversified*** or ***nondiversified***. This distinction is based on the business interests of the company.

- A ***diversified*** holding company's thrift and related activities[1] represent less than 50 percent

[1] Related activities are specified in 12 CFR 584.2(b), 584.2-1 and 584.2-2.

of the company's consolidated net worth and consolidated earnings.

- A ***nondiversified*** holding company is one that does not meet both of these thresholds, and, thus, has banking and banking related businesses as its principal operation.

The vast majority of OTS regulated holding companies are nondiversified.[2]

You may also encounter other types of holding companies. One is a ***mutual holding company (MHC)***. A MHC structure combines the elements of a mutual thrift, which is owned/controlled by its depositors and, in some cases by its borrowers, with elements of a stock thrift. In a MHC, the depositors (and borrowers, if applicable) own/control the mutual holding company, which in turn holds a majority of the voting stock of its subsidiary thrift. The remainder of the thrift stock can be sold to outside investors to raise capital. Some MHCs have mid-tier stock holding companies.

Another structure is a ***HOLA 10(l) holding company***. Section 10(l) of the Home Owners' Loan Act (HOLA) allows state savings banks and cooperative banks that are not regulated by OTS to elect to be treated as savings associations for purposes of regulating their holding company. Without such an election, these holding companies would otherwise be regulated by the Board of Governors of the Federal Reserve (Federal Reserve) as bank holding companies. In order to qualify as a HOLA 10(l) holding company, the subsidiary bank must be a qualified thrift lender. These structures present novel examination concerns because OTS regulates the holding company, but not the subsidiary financial institution. Specific examination issues for this population of holding companies are contained in Section 910.

A third type of structure is one in which a bank or financial holding company controls both a bank and a thrift. Although these companies control a thrift, they are considered bank holding companies and are, therefore, regulated by the Federal Reserve. OTS is the primary regulator of the thrift itself, but does not regulate the holding company.

Structure is one of the first indicators of how a holding company enterprise should be reviewed from an examination perspective. There is a substantial difference in approach between a low risk holding company that does nothing but hold a thrift compared to one that not only holds a thrift, but is also involved in a variety of nonbanking businesses. A complex holding company may be involved in other businesses through various nonthrift subsidiaries. Such increased complexity requires us to assess the effect these businesses may have on the thrift.

The holding company examination encompasses a review of the entire holding company enterprise. Understanding the structure is essential if you are to make an effective assessment of the holding company's condition and its impact on the thrift. Understanding the structure also makes it easier to focus attention on the entities that have the most potential impact on the thrift.

ACQUISITIONS AND CONTROL

The issue of control is very significant in the regulatory process since we are dealing with who has the power over management and policies, and, thus, the direction of the thrift or holding company.[3] It is also important to be aware of

[2] You should note that diversified status is something that a holding company claims. To claim this status, it has to demonstrate that the above percentages are met. Historically, this status was claimed because diversified holding companies were exempt from certain regulatory requirements. In the past, the most notable exception dealt with debt notices. Today, very few regulatory distinctions remain. One exemption that still exists for diversified holding companies is contained in the management interlock regulations.

[3] Direct or indirect control of a thrift by the same person or group of persons that control a foreign bank raises unique supervisory concerns. For a better understanding of the characteristics and potential risks associated with such parallel-owned banking organizations, see the Joint Agency Statement on Parallel-Owned Banking Organizations included as Appendix 400A.

potential acquirers of control. As noted above, a holding company is a company that controls a thrift, directly or indirectly. Specific statutory and regulatory requirements apply to such companies, starting with the fact that OTS must grant approval before any company can acquire control of a thrift. You must understand the control thresholds and presumptions in order to recognize situations where a controlling party has not been properly identified, and, therefore, has not received the requisite approvals from the OTS.

Control of a thrift or holding company can take various forms and, many times, is not obvious. The following highlights some simple facts about control:

- Control can be acquired directly or indirectly.
- Control can occur by persons or entities acting in concert to influence the thrift or holding company.
- Control can be acquired by means other than stock ownership.

For the most part, control of a thrift or holding company is fairly straightforward based on stock ownership or the ability to control the stock in some manner. Such situations are ordinarily acknowledged by the parties, and the proper application or notification process to the OTS is undertaken.

However, there are also situations where the question of control becomes somewhat murky. It is these situations where you need to be aware of possible control issues which have not been acknowledged, and which have not been reviewed by the OTS.

Some of these latter type situations may involve circumstances where control is "backed into." For example, if a holding company or thrift repurchases stock on a non pro rata basis. Such a repurchase will raise the percentage of ownership of the remaining shareholders. Someone who once owned only nine percent of voting stock may own 11 percent after the stock repurchase is completed. There may also be proportional ownership shifts as a result of corporate changes such as mergers with, or purchase of, another thrift or holding company. Further, beneficial ownership interests that carry the right to acquire stock through, for example, exercisable options, may result in control.

The regulations covering acquisition and control issues are found at 12 CFR Part 574. Determinations of control can be very complex, and conclusions may well have to be made outside the scope of the examination. However, it remains important that you are aware of the more significant elements of control to be able to identify and make preliminary assessments of any control issues encountered during the examination.

Conclusive Control

Conclusive control is essentially a situation where an acquirer, either person or company, owns or controls more than 25 percent of the voting stock of a thrift or holding company. This can arise from outright ownership or holding irrevocable proxies or a combination of both. In addition, if a person or company exercises a controlling influence over the management or policies of the entity, including controlling the election of a majority of directors, then the acquirer is considered to have conclusive control. An acquirer can also have conclusive control if it is a general partner or trustee of the entity, or has contributed more than 25 percent of the capital of a holding company.

Rebuttable Control

Rebuttable control occurs when a person or company does not have conclusive control, but there are circumstances present that, taken together, suggest that a controlling influence may exist. These circumstances generally involve holding ten percent or more of the voting stock, or 25 percent or more of any class of stock, together with a control factor. The control factors are detailed in the regulation at section 574.4(c). For example, an acquirer might have between 10 and 25 percent of the voting stock of the thrift, but be one of the two largest holders of any class of voting stock. Rebuttable control may also arise through holdings of revocable proxies, under section 574.4(b)(2).

Prior to acquiring the stock, or triggering any other element that gives rise to the rebuttable control issue, the acquirer must either:

- Acknowledge their intent to control, and obtain the appropriate approvals to do so; or
- Successfully rebut control.

In the later case, the OTS must accept the rebuttal before the transaction is consummated. The ability to rebut control enables passive investors who do not intend to control or influence the thrift or holding company to have a sizeable investment without undergoing the process and scrutiny of an acquisition filing. However, if the rebuttal is not accepted, then the acquirer would have to proceed with an application or notice to OTS in the normal course of acquisition discussed below.

Acting in Concert

In assessing control issues, there is the possibility that persons or entities may be acting in concert to secure control. **Acting in concert** is best described as a process whereby persons or entities exercise conclusive or rebuttable control by collectively acting together.

Section 574.4(d) sets forth several rebuttable presumptions of concerted action. Parties may rebut a presumption of concerted action by filing a submission supporting their contention that no concerted action exists. OTS may accept a rebuttal that meets applicable standards under section 574.4, including showing by clear and convincing evidence that concerted action does not exist. Even where concerted action presumptions do not apply, parties may be considered to act in concert under the general definition at 574.2(c).

Application Process

In addition to the rebuttals of control and concerted action discussed above, there are several other control related filings.

Companies seeking to acquire control of a thrift or thrift holding company must file one of several holding company acquisition filings referred to as H-(e) applications. When an individual or person seeks to acquire control, a Change-in-Control notice generally must be filed. Section 574.6 sets forth the procedural requirements and outlines the appropriate type of application or notice for each acquirer. These processes are required whether control is conclusive or, in a rebuttable scenario, where the acquirer does not dispute control or OTS has not accepted a prior rebuttal submission.

Individuals or companies that acquire ten percent or more ownership of any class of stock, but do not trigger the rebuttable or conclusive control thresholds, must file a certification of ownership. The required language of the certification is specified in 12 CFR 574.5.

Application forms and detailed filing instructions for holding companies and ownership control are contained in the Applications Processing Handbook.[4] If you identify a control situation where the appropriate application or notice has not been filed, you should review the exemptions set forth at 12 CFR 574.3(c) and (d), before citing a violation or seeking corrective action. There are a few limited instances where approval or notice is either not required at all, or is allowed after the acquisition. One example is where control results from a pledge or hypothecation of stock to secure a loan.

Once you have a clear understanding of the holding company structure, including identifying all controlling parties and affiliates, you can then begin to analyze the activities conducted.

ACTIVITIES

Many factors go in to determining the permissible activities for a holding company. Some holding companies operate without any activities limitations, while others are subject to activities restrictions.

Even when activity restrictions do apply, there are a significant number of businesses that have been deemed related to banking. Therefore, it is im-

[4] The Application Processing Handbook is available on the OTS website at www.ots.treas.gov.

portant that you review what activities are conducted within the holding company enterprise, and what risks they present.

To determine whether activity restrictions apply, you must consider the following factors:

- Holding company type – unitary or multiple;
- Whether the holding company came into existence or filed an application to become a savings and loan holding company prior to May 4, 1999; and
- Whether the subsidiary thrift(s) have Qualified Thrift Lender (QTL) status.

The following table is provided as a quick reference to the factors that determine what activities are permissible. The discussion that follows explains the terminology used.

Type of HC +	***HC in Existence or Filed Application by 5/4/1999 +***	***QTL Status =***	***Activity Limitations***
Unitary	Yes	Yes	**No**
Unitary	Yes	No	**Yes**
Unitary	No	Yes or No	**Yes**
Multiple[5]	Yes	Yes	**Yes or No**
Multiple	Yes	No	**Yes**
Multiple	No	Yes or No	**Yes**

[5] As discussed on the next page, for a multiple holding company to have no activity limitations, all or all but one of the subsidiary thrifts must have been acquired as part of a supervisory acquisition.

Type of Holding Company

As noted in the beginning of this Section, a unitary holding company is a holding company that controls one thrift. A multiple holding company controls more than one thrift. In addition to this general definition, if an insider of the holding company controls another thrift, then special treatment will apply. Specifically, if an individual meeting the following criteria controls more than one savings association (directly or indirectly), then any holding company controlled by that individual is treated as a multiple holding company in determining whether activity restrictions apply. The individuals that this provision applies to are:

- Directors or officers of a holding company, or
- Individuals who own, control, or hold with the power to vote (or hold proxies representing) more than 25 percent of the voting shares of the holding company.

The significance of being a unitary or multiple holding company is that multiple holding companies must acquire all, or all but one, of their thrifts as part of a supervisory acquisition to be free from activity restrictions. This requirement applies in addition to the qualified thrift lender status and the date of acquisition/application discussed below. To qualify as a supervisory acquisition, provisions of Sections 13(c), 13(i) or 13(k) of the Federal Deposit Insurance Act, or the former Section 408(m) of the National Housing Act must have been invoked.

In addition to whether the holding company is unitary or multiple, you must also consider whether it is a mutual holding company. As discussed further in Section 920, all mutual holding companies are subject to activities restrictions.

Date of Acquisition or Application

The Gramm-Leach-Bliley Act (GLB), enacted in November 1999, restricted the creation of new thrift holding companies that engage in commercial or other nonfinancial activities. The GLB did, however, grandfather most holding compa-

nies in existence at the time. Specifically, those holding companies that were in existence on May 4, 1999, and those that had filed an application on or before May 4, 1999, to acquire a thrift, can operate without activity restriction if both of the following are met:

- The holding company continues to hold at least one thrift (or its successor) that it controlled on May 4, 1999, or that it acquired under an application pending with the OTS on or before that date; and
- The subsidiary thrift(s) have QTL status.

As noted, a multiple holding company must also have acquired all, or all but one, of its subsidiary thrifts in a supervisory acquisition.

Qualified Thrift Lender Status

To operate without activity restrictions, all of the holding company's subsidiary thrifts must be qualified thrift lenders. This means that the thrift must satisfy either the:

- OTS QTL Test; or
- Internal Revenue Service tax code Domestic Building and Loan Association (DBLA) test.

To be a QTL under the OTS test, the thrift must maintain qualifying thrift investments equal to or exceeding 65 percent of portfolio assets for 9 out of every 12 months. Initially, these investments were predominantly mortgage loans and mortgage-related securities. However, 1996 legislation liberalized the definition to include small business loans, education loans, and credit card loans. This allowed a thrift to expand its consumer type portfolios without the consequence of losing its QTL status.

To be a QTL under the DBLA test (IRS regulation 20 CFR Section 301.7701-13A), a thrift must meet a "business operations test" and a "60 percent assets test."

If the subsidiary thrift fails to maintain its QTL status, the holding company's activities are restricted. Further, it must discontinue any nonpermissible business, although the OTS may grant a grace period up to two years for good cause. Nonetheless, any company that controls a thrift that does not have QTL status must register as a bank holding company within one year of the thrift's failure to meet the QTL test.

Permissible Activities

If activities restrictions apply, you must determine whether the activities conducted by the holding company and other affiliates are permissible. The following activities are permissible for all holding companies:

- Furnishing or performing management services for its thrift subsidiary;
- Conducting an insurance agency or an escrow business;
- Holding, managing, or liquidating assets owned by, or acquired from, its thrift subsidiary;
- Holding or managing properties used or occupied by its thrift subsidiary;
- Acting as trustee under deed of trust;
- Any other activity that the Board of Governors of the Federal Reserve System has permitted for financial holding companies under Section 4(k) of the Bank Holding Company Act (as outlined in 12 CFR 225.86 or 225.88 and 225.89); and
- Any activity that multiple savings and loan holding companies were authorized (by regulation) to engage in directly on March 5, 1987.[6]

[6] These activities are outlined in 12 CFR 584.2-1 (including, for example, investment in various lending transactions, furnishing various services to affiliates, and acquiring improved and unimproved real estate).

Prohibited Acts and Acquisitions

Evasion of Laws and Regulations. Despite the broad range of activities that thrift holding companies can engage in, there is a general prohibition regarding evasion of laws and regulations. Section 584.2(a) prohibits a holding company from engaging in any activity or rendering any service with the purpose of evading any law or regulation that applies to the thrift. You must exercise judgment in deciding what is an evasion of law or regulation as opposed to a company structuring its operations to take full advantage of the flexibility that holding companies and their subsidiaries possess. The deciding factor ultimately revolves around the holding company's purpose and intent, as well as the effect on the thrift.

Multi-State Multiple Holding Companies. Section 574.3(e) generally prohibits the formation of an interstate multiple thrift holding company. Unless certain criteria are met, this applies to any acquisition that would result in a holding company that controls thrifts in more than one state where the thrifts were not previously affiliated.

Nonaffiliated Ownership. Section 584.4 generally prohibits the acquisition of voting stock of nonaffiliated thrifts or thrift holding companies. Specifically, unless several exceptions apply, no thrift holding company may acquire more than five percent of the voting stock of a thrift or thrift holding company that is not a subsidiary, except with OTS approval. Nor can any multiple thrift holding company acquire more than five percent of the voting stock of any company that is not a subsidiary unless that company is engaged in the bulleted permissible activities noted above.

Other Prohibited Acts. Section 584.9 outlines other prohibitions regarding control of mutual thrifts, management interlocks, and convicted persons. These regulatory provisions are discussed further in Relationship Section 500.

Risk Assessment

The above discussion regarding structure, ownership and control issues, and activities is based on what a holding company can do by law and regulation. However, the fact that these objective criteria are met does not mean that there are no supervisory concerns. As in all examination areas, subjective judgments must be made about how well the holding company is being operated. A well designed structure can be undermined when implemented by management.

As outlined above, control of a thrift holding company can take many forms. Similarly, persons or entities exercising that control have widely diverse interests. In most cases, those interests are to oversee and reasonably benefit from the success of the entire organization. However, there may be parties that abuse their control relationship. You need to be able to identify control issues and be alert for any evidence of corporate abuse. You must be particularly watchful for indications that the thrift is the target of abuse for the benefit of other corporate interests. Similarly, you should identify situations where the thrift is not material to the diverse interests of the holding company or its controlling shareholders, and, therefore, vulnerable to a lack of support or inadequate oversight.

The current businesses and transactions of some holding companies are very diverse. The risks created by these activities can range from minor to significant and from permissible to inappropriate. Increased risk taking in holding company investments or businesses not only creates a potential detriment to the holding company itself, it also increases the risk that the subsidiary thrift will be negatively affected.

Your examination must review the businesses and investments of the holding company enterprise and assess the level of risk that is being taken. You should review, for example, whether risks are within the norm for the particular industry. Additionally, you should note whether company investments and other assets are within the ordinary course for the business, or whether they are more speculative. Most importantly, you must determine how these risks affect the insured thrift. Your assessment is not only how the thrift is affected currently; but potential risks as well. The holding company may currently be experiencing

success and the thrift may be financially secure. However, there may be elements within that business structure that have the potential for problems. These need to be identified and considered in the overall holding company rating.

RATING THE ORGANIZATIONAL STRUCTURE COMPONENT

To properly assess risk at the holding company, you must consider the entire holding company enterprise. Specifically, you must consider the parties that control the thrift, how the thrift fits in the overall structure, and the activities conducted by the nonbank subsidiaries of the holding company.

You should assign an ***organizational structure component rating of "1"*** when there are no control issues and activities are conducted prudently with reasonable risk. All activities engaged in are permissible relative to the holding company structure.

You should assign an ***organizational structure component rating of "2"*** when activities and lines of business have a neutral effect on the thrift. Any control or activity concerns are addressed in a timely matter when advised, but may not have been independently identified. Activities may present some risk, but the risk is adequately managed, and does not jeopardize the safety and soundness of the thrift.

You should assign an ***organizational structure component rating of "3"*** when there is disregard for control issues or other ownership abuse. A holding company in this category may knowingly engage in impermissible activities. It may accept unreasonable risks or ineffectively manage risks in its activities and lines of business, whether or not permissible, that have negative implications for the holding company or the thrift.

SUMMARY

Thrift holding companies can have various corporate structures and these forms relate to not only the operating ability of these entities, but also how they should be assessed during the examination. Likewise, control of the entities may come about in numerous ways. Control may be conclusive or rebuttable. You must be knowledgeable of, and watchful for, a variety of events that could result in a change of control.

Once structure and control issues have been determined, the actual operation of these entities must be investigated. All material business activities must be identified. You must determine if the activities are permissible for the holding company structure. Finally, you should identify, to the extent possible, risks within the holding company enterprise that may affect the thrift so that appropriate supervisory measures may be initiated.

See Attached Joint Agency Statement on

Parallel-Owned Banking Organization

JOINT AGENCY STATEMENT ON PARALLEL-OWNED BANKING ORGANIZATIONS

PURPOSE

This statement discusses the characteristics of parallel-owned banking organizations, reviews potential risks associated with these banking organizations, and sets forth the approach of the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision (collectively, "the banking agencies") to supervision of those risks. It also provides information on the applications process for proposals involving parallel-owned banking organizations.

The banking agencies' supervisory approach seeks to better understand how the overall strategy and management of a parallel-owned banking organization affects a U.S. depository institution within such a structure, how the activities of foreign affiliates are supervised, how home-country supervisors view the condition and operations of foreign affiliates, and how affiliates could affect the U.S. depository institution. Through this understanding, the banking agencies may be better able to monitor and address risks affecting a U.S. depository institution that arise in parallel-owned banking organizations. Enhanced communication and cooperation with foreign bank supervisors is important to this process.

The supervisory approach outlined in this statement cannot eliminate the risks inherent with a parallel-owned banking structure. However, this supervisory approach may assist the banking agencies in determining the extent of inter-organizational transactions, for example, loan participations or sales, insider loans and contractual obligations for services. The banking agencies may also be better able to assess the effects that another member of the organization may have on a U.S. depository institution.

IDENTIFYING PARALLEL-OWNED BANKING ORGANIZATIONS

A parallel-owned banking organization is created when at least one U.S. depository institution and one foreign bank[1] are controlled either directly or indirectly by the same person or group of persons[2] who are closely associated in their business dealings or otherwise acting in concert. It does not include structures in which one depository institution is a subsidiary of the other, or the organization is controlled by a company subject to the Bank Holding Company Act, 12 USC

[1] References to "foreign bank" or "foreign parallel bank" also include a holding company of the foreign bank and any U.S. or foreign affiliates of the foreign bank. References to "U.S. depository institution" do not include a U.S. depository institution that is controlled by a foreign bank.

[2] The term person(s) includes both business entities and natural person(s), which may or may not be U.S. citizens.

1841 *et seq*., or the Savings and Loan Holding Company Act, 12 USC 1467a.[3] The banking agencies consider whether a person or group of persons may control a depository institution if the person or group of persons controls 10 percent or more of any class of voting shares of the depository institution.[4]

The characteristics listed below may be indicators that a U.S. depository institution is directly or indirectly controlled by a person or group of persons that also controls a foreign bank. If one or more of the following factors exist, depending upon the circumstances, the banking agencies may conduct additional inquiries:

- An individual or group of individuals acting in concert that controls a foreign bank also controls any class of voting shares of a U.S. depository institution; or financing for persons owning or controlling the shares is received from, or arranged by, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock purchase loan.

- The U.S. depository institution has adopted particular or unique policies or strategies similar to those of the foreign bank, such as common or joint marketing strategies, sharing of customer information, cross-selling of products, or linked Web sites.

- An officer or director of the U.S. depository institution either: 1) serves as an officer or director[5] of a foreign bank; or 2) controls a foreign bank or is a member of a group of individuals acting in concert or with common ties that controls a foreign bank.

- The name of the U.S. depository institution is similar to that of the foreign bank.

Parallel-owned banking organizations are established and maintained for a variety of reasons, including tax and estate planning, and risks of nationalization. While these reasons may be legitimate and not prohibited by U.S. or foreign law, the structure of such organizations creates or increases the risks outlined below and may make it more difficult for supervisors to monitor and address such risks.

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[3] The approach outlined in this statement applies only to those parallel-owned banking organizations that are not controlled by a "bank holding company" under the Bank Holding Company Act or a "savings and loan holding company" under the Savings and Loan Holding Company Act. Such companies would be subject to the application, notice, and supervisory requirements in the Bank Holding Company Act or Savings and Loan Holding Company Act and not the procedures described in this statement and other related issuances. A bank holding company or savings and loan holding company, however, may be a component of a parallel-owned banking organization. This situation may arise when a bank holding company or savings and loan holding company controls the U.S. depository institution, and the holding company, in turn, is controlled by a person or group of persons who also controls a foreign bank.

[4] A variety of presumptions of control and technical rules apply to determinations of control. *See* 12 CFR 5.50, 225.41, 303.82, 574.4.

[5] The sharing of a director, by itself, is unlikely to indicate common control of the U.S. and foreign depository institutions.

SUPERVISORY RISKS IN PARALLEL-OWNED BANKING ORGANIZATIONS

Parallel-owned banking organizations present supervisory risks similar to those arising from chain banking organizations in the United States. The fundamental risk presented by these organizations is that they may be acting in a *de facto* organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision. Consequently, relationships between the U.S. depository institution and other affiliates may be harder to understand and monitor. This risk can be reduced but not eliminated by (1) working with the appropriate non-U.S. supervisors to better understand and monitor the activities of the foreign affiliates and owners; (2) sharing information, as appropriate, with foreign and domestic banking supervisory agencies with supervisory responsibility for other entities within the organization; and (3) imposing special conditions or obtaining special commitments or representations related to an application or enforcement or other supervisory action, where warranted.

Parallel-owned banking organizations may raise numerous management and supervisory risks, including:

- Officers and directors of the U.S. depository institution may be unable or unwilling to exercise independent control to ensure that transactions with the foreign parallel bank or affiliates are legitimate and comply with applicable laws and regulations. As a result, the U.S. depository institution may be the conduit or participant in a transaction that violates U.S. law or the laws of a foreign country, or that is designed to prefer a foreign bank or nonbank entity in the group, to the detriment of the U.S. depository institution.

- Money laundering concerns may be heightened due to the potential lack of arms-length transactions between the U.S. depository institution and the foreign parallel bank. Specifically, the flow of funds through wires, pouch activity, and correspondent accounts may be subject to less internal scrutiny by the U.S. depository institution than usually is warranted. This risk is greatly increased when the foreign parallel bank is located in an offshore jurisdiction or other jurisdiction that limits exchange of information through bank secrecy laws, especially if the jurisdiction has been designated as a "non-cooperating country or territory," or the jurisdiction or the foreign bank has been found to be of primary money-laundering concern under the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001.[6]

- Securities, custodial, and trust transactions may be preferential to the extent that assets, earnings, and losses are artificially allocated among parallel banks. Similarly, low-quality assets and problem loans can be shifted among parallel banks to manipulate earnings or losses and avoid regulatory scrutiny. Also, if the foreign parallel bank were to begin experiencing financial difficulties, the foreign bank or the common owners might pressure the U.S. depository institution to provide credit support or liquidity to an affiliate in excess of the legal limits of 12 USC 371c, 371c-1.

[6] Certain requirements also may apply if a jurisdiction or a foreign bank is found to be of primary money laundering concern under the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001. Pub. L. No. 107-56, 115 Stat. 272, 296 (2001).

- The home country of the foreign parallel bank may have insufficient mechanisms or authority to monitor changes in ownership or to ensure arms-length intercompany transactions between the foreign parallel bank and other members of the group, including the U.S. depository institution, or to monitor concentration of loans or transactions with third parties that may present safety and soundness concerns to the group.

- Capital may be generated artificially through the use of international stock purchase loans. Such loans can be funded by the U.S. depository institution to the foreign affiliate or to a nonaffiliate with the purpose of supporting a loan back to the foreign affiliate and used to leverage the U.S. depository institution or vice versa. This concern is heightened for parallel-owned banking organizations if the foreign bank is not adequately supervised.

- Political, legal, or economic events in the foreign country may affect the U.S. depository institution. Events in the foreign country, such as the intervention and assumption of control of the foreign parallel bank by its supervisor, may trigger a rapid inflow or outflow of deposits at the U.S. depository institution, thereby affecting liquidity. Foreign events may increase reputational risk to the U.S. depository institution. In addition, these events may adversely affect the foreign bank owner's financial resources and decrease the ability of the foreign bank owner to provide financial support to the U.S. depository institution. Foreign law may change without the U.S. depository institution or the banking agencies becoming aware of the effect of legal changes on the parallel-owned banking organization, including the U.S. depository institution.

- Parallel-owned banking organizations may seek to avoid legal lending limits or limitations imposed by securities or commodities exchanges or clearinghouses on transactions by one counterparty thereby unduly increasing credit risk and other risks to the banking organizations and others.

To minimize these risks, the banking agencies will coordinate their supervision of a parallel-owned banking organization's U.S. operations. The supervisory approach may include unannounced coordinated examinations if more than one regulator has examination authority. Such examinations may be conducted if regulators suspect irregular transactions between parallel-owned banks, such as the shifting of problem assets between the depository institutions. Factors to consider in determining whether to conduct coordinated reviews of an organization's U.S. operations include: intercompany and related transactions; strategy and management of the parallel-owned banking organization; political, legal, or economic events in the foreign country; and compliance with commitments or representations made or conditions imposed in the application process or pursuant to prior supervisory action.

The banking agencies expect the U.S. depository institution's board of directors and senior management to be cognizant of the risks associated with being part of a parallel-owned banking structure, especially with respect to diversion of depository institution resources, conflicts of interest, and affiliate transactions. The depository institution's internal policies and procedures should provide guidance on how personnel should treat affiliates. The banking agencies expect to have access to such policies as well as the results of any audits of compliance with the policies.

The banking agencies will seek an overview of the entire organization, as well as a better understanding of how foreign bank affiliates are supervised. Authorized members of supervisory staff will work with foreign supervisors to better understand the activities of the foreign affiliates and owners. As appropriate and feasible, and in accordance with applicable law, authorized staff members of the banking agencies will share information regarding material developments with foreign and domestic supervisory agencies that have supervisory responsibility over relevant parts of the parallel-owned banking organization.

APPLICATION PROCESS FOR PROPOSALS INVOLVING PARALLEL-OWNED BANKING ORGANIZATIONS

A person or group of persons who are closely associated in their business dealings or otherwise acting in concert may establish or acquire control of a foreign bank and subsequently establish or acquire control of a U.S. depository institution, where one depository institution is not a subsidiary of the other. This establishment or acquisition of a U.S. depository institution would be subject to the Change in Bank Control Act, the Bank Holding Company Act, the Federal Deposit Insurance Act, or the Savings and Loan Holding Company Act. The banking agencies' policies and procedures for processing applications, including filings under the Change in Bank Control Act, the Bank Holding Company Act, the Federal Deposit Insurance Act, or the Savings and Loan Holding Company Act may be found in regulations and guidance issued by the banking agencies. As with all types of applications, the banking agencies review proposals involving parallel-owned banking organizations on a case-by-case basis, including a review of the corporate structure of the proposed transaction. Therefore, information required, commitments or representations requested, and the imposition of special conditions in a regulatory decision may differ for each applicant or notificant. Depending on specific circumstances, the banking agencies may place additional restrictions on the U.S. depository institution's ability to engage in transactions with foreign affiliates or may impose other restrictions, as applicable.

U.S. depository institutions that learn of the possibility of becoming part of a parallel-owned banking organization should promptly advise the appropriate federal banking agency. Experience shows that obtaining all of the information necessary to gain a complete understanding of the foreign bank, which may require working with the foreign bank supervisor, and an understanding of the impact of the proposal on the U.S. depository institution, can be more complicated and time-consuming in a potential parallel-owned banking organization situation than is ordinarily the case.

ACKNOWLEDGEMENT TO THE APPROPRIATE FEDERAL BANKING AGENCY THAT A U.S. DEPOSITORY INSTITUTION HAS BECOME PART OF A PARALLEL-OWNED BANKING ORGANIZATION

A person or group of persons may first establish or acquire control of the U.S. depository institution and then the foreign bank, where one depository institution is not a subsidiary of the other, or the U.S. depository institution and the foreign bank are not subsidiaries of the same bank holding company or savings and loan holding company. In this instance, a parallel-owned banking organization would be formed without the review of the banking agencies in the application process.

To the extent possible, in order to assure that the U.S. depository institution is properly supervised and identified as part of a parallel-owned banking organization, a U.S. depository institution should provide an acknowledgement to the appropriate federal banking agency prior to becoming part of a parallel-owned banking organization. A U.S. depository institution's management should advise the individuals who control the depository institution to inform management before they obtain control of a foreign bank. If providing this acknowledgement in advance is not possible, the U.S. depository institution should inform the banking agency promptly after learning of the acquisition of control, so that the banking agency may adjust its supervisory strategy expeditiously and assist the U.S. depository institution in identifying and controlling any risks presented by membership in a parallel-owned banking organizations.

INTRODUCTION

Increasingly, thrifts are becoming parts of highly integrated corporate structures. They are more frequently being acquired as a key component of an overall strategy to provide comprehensive financial services. These affiliations can involve outsourcing of critical functions of the thrift and cross marketing of products. As a result, these thrifts may be subject to decisions that are made with regard to the best interest of the corporate structure, without considering the potential positive or negative impact on the thrift standing alone. This highlights the need for increased supervisory attention to ensure that actions of an affiliate do not pose a material risk to the safety, soundness, or stability of the subsidiary thrift.

Companies in a holding company enterprise are more likely to abuse the relationship with the thrift when they have a high risk profile or experience financial difficulties. A holding company can negatively affect the thrift by pressuring it to:

- Provide resources to the holding company or other affiliates;
- Take on additional risk; or
- Enter into transactions that it normally would not enter into.

The risk profile of a holding company enterprise can strategically, or inadvertently, be altered by:

- Entering into new activities without thoroughly evaluating the risks or failing to implement policies and procedures to manage such risk;
- Making risky investments;
- Engaging in potentially abusive transactions with insiders or other affiliates;
- Incurring significant debt;
- Issuing trust preferred or other hybrid securities without a well thought out plan as to how to deploy the proceeds; or
- Growing without adequate capital support.

Even activities or investments that appear to present little risk can adversely impact the thrift if they are mismanaged. Losses or lower than anticipated returns can result in the holding company exerting undue pressure on the thrift to help meet the demands of its other obligations. Such pressures can result in key decision makers providing inadequate oversight over the thrift relationship or endorsing inappropriate actions with regard to the best interests of the thrift.

As reiterated throughout this Handbook, the primary purpose of a holding company examination is to assess the effect of the holding company enterprise on the safety and soundness of its subsidiary thrift. **In many respects, your conclusions about the relationship between the thrift and the holding company enterprise will rely upon findings you made in other components of the holding company examination.**

While being concerned with the potential adverse ways in which a holding company may impact the thrift, you should not overlook the fact that many holding company relationships have the potential to offer benefits to the thrift. A thrift's integration in a holding company enterprise can lead to significant economies of scale for the corporate family as a whole. In addition, it is not unusual for a thrift to benefit from the experience and expertise of key decision makers within the holding company enterprise. The thrift may also benefit from the holding company's reputation, but you must realize that this is a double-edged sword. The thrift may also suffer from its holding company's reputation if it becomes poor, either due to financial reverses or adverse publicity from litigation. This is especially the case if the thrift has a similar name or is otherwise linked in the public's mind. Therefore, you must objectively evaluate the relationship component by assessing the:

- Influence that the controlling shareholders and other companies in the holding company enterprise have on the thrift and the role the thrift plays in achieving the overall goals and objectives of the holding company enterprise; and
- Effectiveness of the primary decision makers with respect to overseeing the operations of the thrift.

ASSESSING THE HOLDING COMPANY ENTERPRISE'S INFLUENCE ON THE THRIFT

You can draw preliminary conclusions about the nature of the holding company relationship by asking yourself the following questions:

- Are systems and operations interdependent? Are accounting records, bank accounts or transactional records commingled? Would it be difficult or even impossible for the thrift to "stand alone" in the event of the financial collapse of the parent holding company?[1]
- Are key thrift functions outsourced to affiliates, thereby causing the thrift to heavily rely upon the holding company? Do corporate policies facilitate the build-up of franchise value in the thrift?
- Are riskier activities or investments concentrated in the thrift?
- How material is the thrift to the holding company enterprise or its controlling shareholders? In light of their other interests, is the thrift immaterial and, therefore, vulnerable to a lack of support or inadequate oversight?
- Does the level of debt, or earnings volatility, of the holding company or other affiliates pose an undue risk to the thrift?
- Is the holding company (or other affiliates) acquiring investments, other assets, or involved in other activities that could pose risk to the thrift?
- Is the holding company involved in litigation that could adversely effect the thrift due to adverse publicity?
- Does the holding company pressure the thrift to make investments that generate benefits for the holding company or other affiliates, including tax benefits, compensating balances or "quid pro quo" type arrangements?
- Are there significant transactions (especially loans, guarantees, asset sales/purchases, and service contracts) between the thrift and affiliates or between the holding company and insiders or other affiliates that may indirectly impact the thrift?
- Is the holding company management familiar with thrift regulations and accounting practices?
- Are there management ties between the thrift and its holding company? Is the thrift being run independently of the holding company, or are there numerous interlocks within senior management, raising concerns about management loyalty to the thrift?

Evaluating these factors will help you understand the thrift's position within the consolidated entity. It will also reveal any stresses placed upon the thrift by the parent, and disclose weaknesses in nonthrift subsidiaries. You should review the Management Representation letter given to the external auditors. Such letters, or an accompanying letter from their attorney, should detail any pending or threatened litigation that could adversely affect the holding company.

In order to better understand the corporate goals and objectives and holding company relationship, you should review business plans, budgets and board minutes.

[1] Generally a thrift is not directly liable for the debts of a holding company or its other affiliates, and, thus, should be insulated from any serious financial difficulties experienced by such entities. Creditors may, however, attempt to pursue a thrift for repayment of an affiliate's (including a holding company's) unpaid delinquent debt. In most cases, courts will not hold one corporate entity responsible for the debts of the other unless the entities have been intermingled.

Business Plans and Budgets

You should obtain and review a copy of the holding company's business/strategic plan and budget if these documents are available. These documents will assist you in determining the holding company's plans regarding its thrift subsidiary. The budget and pro-forma financial statements will help you reach a conclusion as to whether planned activities are feasible. Encourage holding companies to meet with OTS when considering significant transactions as an effective way to communicate and avoid potential problems.

When no business plan exists, you should discuss the company's plans with senior holding company management. Management should be able to clearly state goals and objectives even if no formal plan is available. There must be evidence of corporate direction. Also, discuss the company's plans with thrift management to determine their understanding of the influence and level of involvement of the holding company. Does thrift management consider the holding company a positive influence that sets appropriate policies, effectively communicates, and properly oversees the operations of the thrift? Or does thrift management view the holding company as subjecting it to excessive risk? What is the thrift's interpretation of where it fits in strategically? Does thrift management feel the two entities achieve synergies, or do they feel the level of interdependence is such that the parent adversely influences the thrift and the thrift's corporate identity is compromised?

Whether by review of written plans or interviews of management, you must determine how the thrift fits within the corporate structure and if there are any plans to significantly change the institution's activities or operations. Plans and budgets should also allow you to identify any anticipated shift in financial policy that affects the thrift, especially policies that relate to dividends, management fees, or the financial condition of the subsidiary thrift. Overall, you should be able to assess whether the plans are prudent or inappropriately increase risk to the thrift.

Board Minutes

Board minutes are a valuable source of information regarding the holding company's plans and activities. You should review the minutes to determine what strategic plans, initiatives and operations were discussed and approved. The board minutes will also disclose what operating policies and procedures were adopted. The board minutes will begin to give you a sense of the effectiveness of the directors and management.

EFFECTIVENESS OF DECISION MAKERS

The board of directors and senior management of the holding company are evaluated on how their actions affect the holding company and the thrift. Management and the board's competence, integrity, and risk sensitivity are assessed with that in mind.

Some holding companies acquire thrifts as passive investments, while others plan to implement integrated cross marketing strategies. The holding company's plans and objectives regarding its control of the thrift will affect how active holding company management is with regard to decisions that affect the thrift.

Other factors, such as the asset size and the proportion of income the thrift contributes within the holding company, will determine how material the thrift is on a consolidated basis. Common sense dictates that the greater the holding company's investment in the thrift, and the more material the thrift is to the holding company's consolidated operations, the more likely that holding company management will exercise significant influence over the thrift. Holding companies that passively invest in a thrift may simply monitor performance as long as they are receiving a reasonable expected rate of return on their investment. These same holding companies may also take a more aggressive management posture when expectations are not met. The effectiveness of management can often impact the thrift. Active management of any company by its directorate and senior management is essential to manage risk. A weak or ineffective board of di-

rectors or management team can fail to identify and address problems within the holding company enterprise that can adversely affect the thrift. Therefore, at least a brief review of management's effectiveness is appropriate.

Another point to consider is that the management of the holding company and the thrift often overlap and may be very similar. While there are regulatory restrictions (and often conditions of approval that OTS imposes at the time of acquisition) that apply to the composition of the thrift's board of directors,[2] no similar restrictions apply to the holding company's directorate.

Even in situations where the board members or management personnel are similar, you should recognize that their roles and responsibilities with respect to the holding company will differ from those of the thrift. You should be watchful for conflicts of interest. Directors, officers, and employees of a thrift owe a fiduciary duty to the thrift and must not advance their own personal or business interests. Individuals that have dual roles at both the thrift and the holding company or other affiliate may find themselves in an awkward situation if the interests of the two entities compete. Similarly, since the holding company can exert influence over the activities and transactions in which the thrift engages, all directors and officers should avoid using this influence in a manner that advances their personal interests at the expense of the thrift.

Board of Directors

Directors should fulfill their legal and fiduciary responsibilities and bring a certain functional expertise to the holding company. As representatives of the holding company in the business community, directors contribute to the company's public image and reputation. This can have a direct effect on the integrity and viability of both the holding company and the subsidiary thrift.

From a legal perspective, directors must control and govern the affairs of the holding company.

[2] See 12 CFR 563.33.

The holding company directorate should include independent directors on the board. These individuals can provide a detached perspective and an analysis for the board of directors.

The OTS "*Directors' Responsibilities Guide*" and "*Directors' Guide to Management Reports*" are available on the OTS website (*ots.treas.gov*). Although written with the thrift director in mind, these resources provide a wealth of information, including references to other publications regarding director responsibilities. In addition, Section 310 of the Thrift Activities Handbook provides information on the oversight role of thrift directors.

As a general matter, directors must:

- Select and retain competent management for the holding company;
- Provide oversight of the company's activities; and
- Review the performance of management.

More specific to holding companies, the directors must oversee the level of risk assumed by its subsidiaries, including the thrift. The board should:

- Approve overall business strategies;
- Approve policies that outline management oversight and risk tolerances; and
- Periodically review and reevaluate the business plan, strategies, and risk management policies and procedures of all significant subsidiaries.

Policies and Procedures

Holding companies, particularly diversified holding companies, may be involved in a wide range of different businesses. These companies should maintain written policies and procedures that outline their approach to managing the various businesses. Holding company management should ensure that policies are in place to prevent practices that put the thrift or the consolidated entity at unacceptable risk.

Review policies and procedures to ensure that they are sound, prudent, and commensurate with the risk profile of the company. Consider how they affect the holding company, as well as the thrift subsidiary. Interview management to ensure they have considered the relevant risks and arrived at a well-reasoned and informed decision to enter each line of business. You should assess the effectiveness of the policies in managing risk. Pay particular attention to the degree of influence the holding company has over the thrift with regard to activities like funding.

Management

While the board is responsible for selecting, reviewing, and compensating management, management is responsible for operating the company under the parameters established by the board. Holding company management has the potential to negatively affect the long-term viability of the holding company, as well as the subsidiary thrift. Because of this, you should perform a focused review of management. You should expand the scope of your review of management when:

- Unusual turnover of senior management occurs;
- Management willingly accepts unusually high risks;
- A major portion of management's compensation is derived from bonuses or stock options that encourage excessive risk taking, especially if such incentives are based on short-term performance;
- There is a concern about the reputation, competence, or credibility of management; or
- A contest for control of the company appears likely.

Key management functions include:

- Providing the board with information for strategic planning;
- Directing the company's activities and monitoring operations;
- Establishing effective internal controls that set appropriate limits on risk-taking; and
- Evaluating performance.

You can identify key managers and their areas of responsibility by reviewing the PERK package, the H-(b)11, or an organizational chart. You can also ascertain management responsibilities through informal interviews with management. Once key officials have been identified, and responsibilities defined, you can consider their qualifications and assess management's overall effectiveness. To do so, you should consider whether management:

- Effectively develops and implements long-range plans to meet goals set by the directorate;
- Adheres to and enforces policies and operating procedures; and
- Ensures adequate internal controls, books, records and systems.

<u>Internal Controls, Books, Records, and Systems</u>

Effective and efficient operations, reliable financial reporting and compliance with relevant laws, regulations and internal policies are products of a good system of internal controls. Such systems are a function of the size, type, organizational structure and complexity of the company. We have seen occasions where holding companies have grown rapidly and have not properly integrated their systems. As a company grows in size and complexity, the systems and depth of the staff should grow in tandem. In addition, complex holding companies, or those with a high risk profile, should have an ongoing dialogue with OTS to get our assessment about the adequacy of their systems and internal controls.

Internal controls and accounting systems should include a mechanism to ensure regulatory compliance and to ensure the thrift maintains corporate separateness. Procedures should exist to both avoid violations and correct noted violations. You should identify any areas of weakness in internal controls, accounting systems and records.

You should then determine the possible effect of such weakness on both the holding company and the insured thrift. An additional source of information is the Management Representation letter to the holding company's external auditors detailing pending or threatened litigation. A pattern of similar legal actions against a holding company may reflect a weakness in internal controls that is resulting in unnecessary litigation. Such litigation not only has monetary costs, but often results in reputational costs as well.

A holding company should be subject to regular internal audits to confirm that it complies with its policies and procedures, and is operating in a safe and sound manner. Material findings should be reported to the board or an appropriately elected audit committee.

Holding companies whose subsidiary thrift(s) have consolidated aggregate assets of $500 million or greater must obtain an independent audit.[3] Such audits must be performed by independent public accountants that satisfy the qualifications outlined in 12 CFR 562.4(d), including the independence requirements and interpretations of the Securities and Exchange Commission. Thrift Activities Handbook Section 350, External Audits, outlines the specific guidelines for OTS-required audits.

EVALUATING INTERCOMPANY TRANSACTIONS AND TAX SHARING ARRANGEMENTS

In many cases, it is appropriate and beneficial for a company to engage in business transactions with its affiliates and insiders. When such transactions directly involve a thrift, however, they may be prohibited by regulation or otherwise objectionable when contrary to the thrift's best interests. Even when transactions do not directly involve the thrift, they may have an indirect impact on the thrift. For example, by making an unsound loan or risky investment, the holding company could jeopardize the financial resources it has available to support its subsidiary thrift. Furthermore, to compensate for a poor investment, the holding company may place additional pressure on the thrift to pay dividends, engage in other transactions, or pursue higher yielding investments.

Transactions Directly With the Thrift

Two areas where, historically, we have observed abuses in the holding company relationship are intercompany transactions and tax sharing arrangements. Both of these can serve as a means to divert funds from the thrift to its holding company. While thrift payments are reviewed in the course of the thrift examination, you can assist in this review by cross-checking the holding company's books and records and its valuation of transactions with those of the thrift. This will allow you to ensure that intercompany transactions, including tax payments, are properly recorded and identified.

In addition to ensuring regulatory compliance and avoiding abuses, evaluating intercompany transactions will:

- Help you understand the thrift's position within the consolidated entity;
- Reveal any stresses placed upon the thrift by the parent; and
- Disclose the relative weaknesses of affiliates.

It is important to distinguish appropriate transactions from those that are, or could become, abusive or are otherwise inconsistent with safe and sound operations. Permissible affiliate transactions should:

- Not be abusive or detrimental to the thrift;
- Be based on safe and sound practices; and
- Comply with applicable statutory and regulatory standards.

[3] See 12 CFR 562.4(b)(2).

OTS regulations regarding transactions with affiliates are found in 12 CFR 563.41 and 563.42.[4] Beyond identifying specific transactions to determine regulatory compliance, you must also strive to understand the motives for such transactions. For additional information on the restrictions and limitations that apply to affiliate transactions, you should refer to Thrift Activities Handbook Section 380, Transactions with Affiliates and Insiders. As noted above, you should coordinate your review of intercompany transactions with the examiner performing the review of affiliate transactions on the thrift examination.

Transactions with Insiders and Other Affiliates that May Indirectly Impact the Thrift

You must not limit your review to transactions that directly involve the thrift. You must also consider transactions that the holding company engages in with its insiders and other affiliates. While the transaction with affiliate regulations at 12 CFR 563.41 and 563.42, and insider lending restrictions at 12 CFR 563.43, do not technically apply to such transactions, you cannot ignore transactions that the holding company enters into with such parties and the potential effect of those transactions on the thrift subsidiary. Despite the fact that you will not apply the specific standards and thresholds outlined in the affiliate and insider regulations that apply to the thrift, you should review these transactions and consider the following elements:

- The principal business of the holding company. If the transaction is a loan, and the principal business of the holding company is to lend money, there may be less of a concern – depending on some of the other factors below. If the holding company is a nonfinancial company, any type of loan would be a red flag.
- The purpose of the transaction. A mortgage on a principal residence would be less of a concern than a loan to support the purchase of the company's stock. Loans to support stock purchases can have the effect of a company's equity being financed by its own debt.
- Whether the company has an ethics or conflicts of interest policy. If so, does the transaction conform with the policy? If not, what type of waiver was given, and who authorized it?
- The terms of the transaction. Was the transaction entered into on favorable terms or at market rates? The more favorable the terms, the greater the possibility of corporate abuse.
- If a loan, the performance of the loan. Is the loan performing? If not, why not and what actions has the holding company taken to address the situation?
- Whether the board of directors or committee of the board approved the transaction. You should use your judgment to determine whether the transaction is material enough to warrant the board's attention. If there was approval, you should determine whether independent directors participated in the decision, and interested directors abstained.
- The size of the transaction in relation to the holding company's capital and other investments, and its potential impact on the holding company's capital, cash flow, and earnings.

It is important that you identify signs of corporate abuse at the holding company. Not only is there reputational risk to the thrift, but if insiders have found a way to abuse the resources of the holding company, you must consider the possibility they will try to find a way to abuse their relationship with the thrift. If you identify a material loan or other transaction that appears problematic, you should:

- Bring the loan or transaction to the attention of senior regional management.
- Discuss the loan with holding company management.

[4] In addition to the transaction with affiliate rules, additional regulatory standards set forth in 12 CFR 563.43 limit how much and on what terms a thrift may lend to its own insiders (directors, officers, principal shareholders and related interests) and insiders of an affiliate.

- Factor the effect of the loan or transaction into your assessment of each component rating, as well as the holding company's overall rating.
- Consider what, if any, supervisory measures are appropriate to safeguard the thrift (for example, limiting dividends from the thrift, requiring prior notice of intercompany transactions, or instructing the holding company to develop and implement policies and procedures to govern transactions with affiliated entities or insiders).

Tax Sharing Agreements

If the timing of tax payments upstreamed to a holding company is too far in advance of when the holding company must submit its taxes, or if a tax refund due to the thrift is not downstreamed promptly by the holding company, it may be considered an unsecured loan and, therefore, a violation of the affiliate regulations.

As a general rule, intercorporate tax settlements between the subsidiary thrift and the consolidated group should result in no less favorable treatment to the institution than if the institution had filed its own separate return. A holding company and its subsidiaries are encouraged to enter into a written, comprehensive tax allocation agreement tailored to their specific circumstances. The respective boards of directors should approve the agreement. The agreement should:

- Limit a subsidiary thrift's tax payments to what the thrift would pay if computing its income taxes on its own;
- Discuss the amount and timing of the thrift's payments for current tax expense, including estimated tax payments;
- Discuss reimbursements to a thrift when it has a loss for tax purposes; and
- Prohibit the payment or other transfer of deferred taxes by the thrift to another member of the consolidated group.

For additional guidance, refer to the "Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure," dated 11/23/98, or contact your regional accountant (see Appendix A).

MANAGEMENT INTERLOCKS

Another aspect of your review of management is its compliance with management interlocks regulations. The Depository Institution Management Interlock Act[5] and the OTS's management interlocks regulation[6], promote competition by generally prohibiting a management official from serving simultaneously with two unaffiliated depository institutions or their holding companies in situations where the management interlock may have an anticompetitive effect. The scope of the prohibition depends on the size and the location of the organizations. For example, management interlocks are *generally* prohibited if both unaffiliated depository organizations, or any depository institution affiliate, have offices in the same community. Management officials cannot serve two unaffiliated depository organizations that have offices or any depository institution affiliate in the same Relevant Metropolitan Statistical Area (RMSA) if both institutions have assets of $20 million or more. A management official of a depository organization (or any depository institution affiliate) with assets of greater than $2.5 billion may not serve as a management official at an unaffiliated depository organization (or any depository institution affiliate) with assets of greater than $1.5 billion.

If management interlocks exist, you need to determine if the interlock falls within the permitted interlocking relationships noted in 12 CFR Section 563f.4. If not, the institution or its holding company may apply to OTS for a general exemption or determine its eligibility for a small market exemption. OTS may grant an exemption if we determine that the official's dual service would not result in a monopoly, a substantial lessening of competition, or otherwise threaten safety and

[5] See 12 USC Sections 3201-3208.

[6] See 12 CFR 363f.

soundness. The small market share exemption allows interlocks for depository organizations (and affiliates) that hold, in the aggregate, no more than 20 percent of the deposits in each RMSA or the community in which both depository organizations (or affiliates), provided that the interlock does not violate the major asset prohibition noted above (12 CFR 563f.5). The depository organization does not need to apply to OTS for the small market exemption, but the institution must maintain records supporting its eligibility for the small market exemption and reconfirm such determination on an annual basis.

Management must institute corrective action if the required prior approval was not obtained. You can detect the existence of management interlocks through:

- Interviews
- Review of minutes
- Review of CIIS, LEXIS/NEXIS, Westlaw/Vutext services
- Contact with other agencies.

RATING THE RELATIONSHIP COMPONENT

The Relationship rating is an assessment of the effectiveness of the holding company's board and senior management, as well as issues associated with the interdependence of the subsidiary thrift. Consider the degree of influence the holding company has over the thrift and how this influence affects thrift operations. Factors in the assessment will include:

- Technical competence, leadership, appointment of officers, management depth, salary administration, budget and tax planning;
- Knowledge of relevant laws and regulations;
- Ability to plan and respond to changing circumstances;
- Ability of holding company management to monitor and direct subsidiary operations to ensure both sound business operation and compliance with holding company policies and procedures;
- Adequacy of system of internal controls, including the internal audit function;
- Dividend Policy; and
- Dependency, indicated by the ability of the holding company and the nonbank subsidiaries to operate independently and not depend on the subsidiary thrift to support them.

You should assign a ***relationship component rating of "1"*** if the holding company serves as a resource to the thrift. The board of directors and executive management of such companies ensure that control is exercised in the best interests of the thrift. They act with integrity, communicate effectively with the thrift and the OTS, and oversee the operations of each entity. The thrift retains independence as a financial institution without adverse influence from the parent. Integrated systems create efficiencies that do not interfere with the thrift's independence. In other words, the thrift could stand alone in the event of a financial collapse by the holding company. Intercompany accounts and relationships reveal no stress placed upon the thrift.

You should assign a ***relationship component rating of "2"*** if the holding company's influence does not adversely impact the thrift. Such companies may show a significant level of influence, possibly insensitive to the fact that the thrift is a separate regulated entity. Nonetheless, the thrift continues to perform acceptably, and the holding company has not caused the thrift to increase its risk profile. Intercompany accounts and relationships show no significant stress placed upon the thrift.

You should assign a ***relationship component rating of "3"*** to holding companies that show a clear disregard for the independent needs of the thrift or the poor financial condition of the holding company enterprise poses an imminent threat to the health and stability of the subsidiary thrift.

There is little effort to insulate the thrift from the risks of other activities conducted in the holding company enterprise. Indeed, there is a distinct lack of appreciation for the importance of separate corporate identities, as indicated by inadequate recordkeeping or controls that distinguish among separate legal entities or by a disturbing pattern of affiliate transactions. Further, the directorate and management of the holding company have demonstrated an inclination to subject the thrift to excessive risk as a result of the activities of the parent and/or the nonbank subsidiaries. Systems are so integrated that there is an excessive reliance by the thrift on the holding company or other affiliates that it would have difficulty standing alone. The thrift's separate corporate identity is severely compromised. The directorate and senior management do not communicate with the OTS regarding major changes in the direction of the company.

SUMMARY

The ability of a holding company to create value for its shareholders and to be a resource for the subsidiary thrift depends to a large extent on the quality of management and the commitment of its directorate.

The relationship between the holding company and its subsidiary thrift is an important factor in the regulation of holding companies. Consider the independence, influence and integration of the thrift, and ultimately whether the board and management act in the best interests of the thrift. To do this, consider:

- Business plans and budgets;
- Intercompany accounts and relationships;
- Tax sharing agreements;
- Quality of management;
- Quality of the board of directors, including their compliance with regulatory and statutory guidelines;
- Effectiveness of management, including whether they properly plan, control and oversee the operations of the institution; and
- The existence of conflicts of interests and management interlocks.

It is important that the activities of the holding company enterprise do not pose undue risk to the thrift and that the operations of either entity are not so integrated that either entity cannot stand alone.

See Attached Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket No. 98–17]

FEDERAL RESERVE SYSTEM

[Docket No. R–1022]

FEDERAL DEPOSIT INSURANCE CORPORATION

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[Docket No. 98–93]

Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Notice of interagency policy statement.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the Agencies) are adopting a uniform interagency policy statement regarding intercompany tax allocation agreements for banking organizations and savings associations (institutions) that file an income tax return as members of a consolidated group. The intent of this interagency policy statement is to provide guidance to institutions regarding the allocation and payment of taxes among a holding company and its depository institution subsidiaries. In general, intercorporate tax settlements between an institution and its parent company should be conducted in a manner that is no less favorable to the institution than if it were a separate taxpayer. This policy statement is the result of the Agencies' ongoing effort to implement section 303 of the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI Act), which requires the Agencies to work jointly to make uniform their regulations and guidelines implementing common statutory or supervisory policies.

DATES: This interagency policy statement is effective November 23, 1998.

FOR FURTHER INFORMATION CONTACT: *OCC:* Gene Green, Deputy Chief Accountant, (202/874–4933), or Tom Rees, Senior Accountant, (202/874–5411), Office of the Chief Accountant, Core Policy Division, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

Board: Charles Holm, Manager, (202/452–3502), or Arthur Lindo, Supervisory Financial Analyst, (202/452–2695), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Diane Jenkins (202/452–3544).

FDIC: For supervisory issues, Robert F. Storch, Chief, (202/898–8906), or Carol L. Liquori, Examination Specialist, (202/898–7289), Accounting Section, Division of Supervision; for legal issues, Jamey Basham, Counsel, (202/898–7265), Legal Division, FDIC, 550 17th Street, NW, Washington, DC 20429.

OTS: Timothy J. Stier, Chief Accountant, (202/906–5699), or Christine Smith, Capital and Accounting Policy Analyst, (202/906–5740), Accounting Policy Division, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

Section 303(a)(3) of the of the CDRI Act directs the Agencies, consistent with the principles of safety and soundness, statutory law and policy, and the public interest, to work jointly to make uniform regulations and guidelines implementing common statutory or supervisory policies. Section 303(a)(1) of the CDRI Act also requires the Agencies to review their regulations and written policies and to streamline those regulations where possible.

In 1978, the FDIC, the OCC, and the Board each published a separate policy statement regarding the allocation and payment of income taxes by depository institutions which are members of a group filing a consolidated income tax return. The OTS provides supervisory guidance on this subject in its Holding Company Handbook. As part of the ongoing effort to fulfill the section 303 mandate, the Agencies have reviewed, both internally and on an interagency basis, the present policy statements and the supervisory guidance that has developed over the years. As a result of this review, the Agencies identified minor inconsistencies in the policy statements and supervisory guidance. Although largely limited to differences in language and not to the substance of the policies and guidelines themselves, the Agencies determined that it would be beneficial to adopt a uniform interagency policy statement regarding intercorporate tax allocation in a holding company structure.

II. Policy Statement

This interagency policy statement reiterates and clarifies the position the Agencies will take as they carry out their supervisory responsibilities for institutions regarding the allocation and payment of income taxes by institutions that are members of a group filing a consolidated return. The interagency policy statement reaffirms that intercorporate tax settlements between an institution and the consolidated group should result in no less favorable treatment to the institution than if it had filed its income tax return as a separate entity. Accordingly, tax remittances from a subsidiary institution to its parent for its current tax expense should not exceed the amount the institution would have paid had it filed separately. The payments by the subsidiary to the parent generally should not be made before the subsidiary would have been obligated to pay the taxing authority had it filed as a separate entity. Similarly, an institution incurring a tax loss should receive a refund from its parent. The refund should be in an amount no less than the amount the institution would have received as a separate entity, regardless of whether the consolidated group is receiving a refund. However, adjustments for statutory tax considerations which may arise in a consolidated return are permitted as long as the adjustments are made on a basis that is equitable and consistently applied among the holding company affiliates. Regardless of the method used to settle intercorporate income tax obligations, when depository institution members prepare regulatory reports, they must provide for current and deferred income taxes in amounts that would be reflected as if the institution had filed on a separate entity basis.

An institution should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to its parent since these are not liabilities required to be paid in the current reporting period. Similarly, transactions in which a parent ''forgives'' any portion of a subsidiary institution's deferred tax liability should not be reflected in the institution's regulatory reports. This is because a parent cannot relieve its subsidiary of this potential future obligation to the taxing authorities, since these authorities can collect some or all of a group liability

from any of the group members if tax payments are not made when due.

Finally, the Agencies recommend that financial institution members of a consolidated group have a written, comprehensive tax allocation agreement to address intercorporate tax policies and procedures.

This interagency policy statement revises and replaces the Board's ''Policy Statement on Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State Member Banks,'' (43 FR 22782, May 26, 1978); the OCC's ''Statement of Policy on Income Tax Remittance to Holding Company Affiliates,'' (Banking Circular No. 105, May 22, 1978); the FDIC's Statement of Policy on ''Income Tax Remittance by Banks to Holding Company Affiliates'' (43 FR 22241, May 24, 1978); and the OTS's ''OTS Tax-Sharing Policy,'' (Section 500, ''Funds Distribution,'' OTS Holding Companies Handbook). This interagency policy statement does not materially change any of the guidance previously issued by any of the Agencies.

The text of the interagency policy statement follows:

Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (''the Agencies'') are issuing this policy statement to provide guidance to banking organizations and savings associations regarding the allocation and payment of taxes among a holding company and its subsidiaries. A holding company and its depository institution subsidiaries will often file a consolidated group income tax return. However, each depository institution is viewed as, and reports as, a separate legal and accounting entity for regulatory purposes. Accordingly, each depository institution's applicable income taxes, reflecting either an expense or benefit, should be recorded as if the institution had filed on a separate entity basis.[1] Furthermore, the amount and timing of payments or refunds should be no less favorable to the subsidiary than if it were a separate taxpayer. Any practice that is not consistent with this policy statement may be viewed as an unsafe and unsound practice prompting either informal or formal corrective action.

Tax Sharing Agreements

A holding company and its subsidiary institutions are encouraged to enter into a written, comprehensive tax allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. Although each agreement will be different, tax allocation agreements usually address certain issues common to consolidated groups. Therefore, such an agreement should:

- Require a subsidiary depository institution to compute its income taxes (both current and deferred) on a separate entity basis;
- Discuss the amount and timing of the institution's payments for current tax expense, including estimated tax payments;
- Discuss reimbursements to an institution when it has a loss for tax purposes; and
- Prohibit the payment or other transfer of deferred taxes by the institution to another member of the consolidated group.

Measurement of Current and Deferred Income Taxes

Generally accepted accounting principles, instructions for the preparation of both the Thrift Financial Report and the Reports of Condition and Income, and other guidance issued by the Agencies require depository institutions to provide for their current tax liability or benefit. Institutions also must provide for deferred income taxes resulting from any temporary differences and tax carryforwards.

When the depository institution members of a consolidated group prepare separate regulatory reports, each subsidiary institution should record current and deferred taxes as if it files its tax returns on a separate entity basis, regardless of the consolidated group's tax paying or refund status. Certain adjustments for statutory tax considerations that arise in a consolidated return, e.g., application of graduated tax rates, may be made to the separate entity calculation as long as they are made on a consistent and equitable basis among the holding company affiliates.

In addition, when an organization's consolidated income tax obligation arising from the alternative minimum tax (AMT) exceeds its regular tax on a consolidated basis, the excess should be consistently and equitably allocated among the members of the consolidated group. The allocation method should be based upon the portion of tax preferences, adjustments, and other items generated by each group member which causes the AMT to be applicable at the consolidated level.

Tax Payments to the Parent Company

Tax payments from a subsidiary institution to the parent company should not exceed the amount the institution has properly recorded as its current tax expense on a separate entity basis. Furthermore, such payments, including estimated tax payments, generally should not be made before the institution would have been obligated to pay the taxing authority had it filed as a separate entity. Payments made in advance may be considered extensions of credit from the subsidiary to the parent and may be subject to affiliate transaction rules, i.e., Sections 23A and 23B of the Federal Reserve Act.

A subsidiary institution should not pay its deferred tax liabilities or the deferred portion of its applicable income taxes to the parent. The deferred tax account is not a tax liability required to be paid in the current reporting period. As a result, the payment of deferred income taxes by an institution to its holding company is considered a dividend subject to dividend restrictions,[2] not the extinguishment of a liability. Furthermore, such payments may constitute an unsafe and unsound banking practice.

Tax Refunds From the Parent Company

An institution incurring a loss for tax purposes should record a current income tax benefit and receive a refund from its parent in an amount no less than the amount the institution would have been entitled to receive as a separate entity. The refund should be made to the institution within a reasonable period following the date the institution would have filed its own return, regardless of whether the consolidated group is receiving a refund. If a refund is not made to the institution within this period, the institution's primary federal regulator may consider the receivable as either an extension of credit or a dividend from the subsidiary to the parent. A parent company may reimburse an institution more than the refund amount it is due on a separate entity basis. Provided the

[1] Throughout this policy statement, the terms ''separate entity'' and ''separate taxpayer'' are used synonymously. When a depository institution has subsidiaries of its own, the institution's applicable income taxes on a separate entity basis include the taxes of the subsidiaries *of the institution* that are included with the institution in the consolidated group return.

[2] These restrictions include the Prompt Corrective Action provisions of section 38(d)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1831o(d)(1)) and its implementing regulations: for insured state nonmember banks, 12 CFR part 325, subpart B; for national banks, 12 CFR 6.6; for savings associations, 12 CFR part 565; and for state member banks, 12 CFR 208.45.

institution will not later be required to repay this excess amount to the parent, the additional funds received should be reported as a capital contribution.

If the institution, as a separate entity, would not be entitled to a current refund because it has no carryback benefits available on a separate entity basis, its holding company may still be able to utilize the institution's tax loss to reduce the consolidated group's current tax liability. In this situation, the holding company may reimburse the institution for the use of the tax loss. If the reimbursement will be made on a timely basis, the institution should reflect the tax benefit of the loss in the current portion of its applicable income taxes in the period the loss is incurred. Otherwise, the institution should not recognize the tax benefit in the current portion of its applicable income taxes in the loss year. Rather, the tax loss represents a loss carryforward, the benefit of which is recognized as a deferred tax asset, net of any valuation allowance.

Regardless of the treatment of an institution's tax loss for regulatory reporting and supervisory purposes, a parent company that receives a tax refund from a taxing authority obtains these funds as agent for the consolidated group on behalf of the group members.[3] Accordingly, an organization's tax allocation agreement or other corporate policies should not purport to characterize refunds attributable to a subsidiary depository institution that the parent receives from a taxing authority as the property of the parent.

Income Tax Forgiveness Transactions

A parent company may require a subsidiary institution to pay it less than the full amount of the current income tax liability that the institution calculated on a separate entity basis. Provided the parent will not later require the institution to pay the remainder of the current tax liability, the amount of this unremitted liability should be accounted for as having been paid with a simultaneous capital contribution by the parent to the subsidiary.

In contrast, a parent cannot make a capital contribution to a subsidiary institution by ''forgiving'' some or all of the subsidiary's deferred tax liability. Transactions in which a parent ''forgives'' any portion of a subsidiary institution's deferred tax liability should not be reflected in the institution's regulatory reports. These transactions lack economic substance because the parent cannot legally relieve the subsidiary of a potential future obligation to the taxing authorities. Although the subsidiaries have no direct obligation to remit tax payments to the taxing authorities, these authorities can collect some or all of a group liability from any of the group members if tax payments are not made when due.

Dated: October 14, 1998.

Julie L. Williams,

Acting Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, October 29, 1998.

Jennifer J. Johnson,

Secretary of the Board.

By order of the Board of Directors.

Dated at Washington, DC, this 5th day of November, 1998.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: October 14, 1998.

By the Office of Thrift Supervision.

Ellen Seidman,

Director.

[FR Doc. 98–31179 Filed 11–20–98; 8:45 am]

BILLING CODE 4810–13–P, 6210–01–P, 6714–01–P, 6720–01–P

[3] See 26 CFR 1.1502–77(a).

DEPARTMENT OF THE TREASURY

Customs Service

Proposed Collection; Comment Request; Lay Order Period—General Order Merchandise

ACTION: Notice and request for comments.

SUMMARY: As part of its continuing effort to reduce paperwork and respondent burden, Customs invites the general public and other Federal agencies to comment on an information collection requirement concerning Lay Order Period—General Order Merchandise. This request for comment is being made pursuant to the Paperwork Reduction Act of 1995 (Pub. L. 104–13; 44 U.S.C. 3505(c)(2)).

DATES: Written comments should be received on or before January 22, 1999, to be assured of consideration.

ADDRESS: Direct all written comments to U.S. Customs Service, Information Services Group, Attn.: J. Edgar Nichols, 1300 Pennsylvania Avenue, NW, Room 3.2C, Washington, DC 20229.

FOR FURTHER INFORMATION CONTACT: Requests for additional information should be directed to U.S. Customs Service, Attn.: J. Edgar Nichols, 1300 Pennsylvania Avenue NW, Room 3.2C, Washington, DC 20229, Tel. (202) 927–1426.

SUPPLEMENTARY INFORMATION: Customs invites the general public and other Federal agencies to comment on proposed and/or continuing information collections pursuant to the Paperwork Reduction Act of 1995 (Pub. L. 104–13; 44 U.S.C. 3505(c)(2)). The comments should address: (1) Whether the collection of information is necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (b) the accuracy of the agency's estimates of the burden of the collection of information; (c) ways to enhance the quality, utility, and clarity of the information to be collected; (d) ways to minimize the burden including the use of automated collection techniques or the use of other forms of information technology; and (e) estimates of capital or start-up costs and costs of operations, maintenance, and purchase of services to provide information. The comments that are submitted will be summarized and included in the Customs request for Office of Management and Budget (OMB) approval. All comments will become a matter of public record. In this document Customs is soliciting comments concerning the following information collection:

Title: Lay Order Period—General Order Merchandise Cost Submissions.

OMB Number: 1515–0220.

Form Number: N/A.

Abstract: This collection is required to ensure that the operator of an arriving carrier, or transfer agent shall notify a bonded warehouse proprietor of the presence of merchandise that has remained at the place of arrival or unlading without entry beyond the time period provided for by regulation.

Current Actions: There are no changes to the information collection. This submission is being submitted to extend the expiration date.

Type of Review: Extension (without change).

Affected Public: Businesses, Individuals, Institutions.

Estimated Number of Respondents: 300.

Estimated Time Per Respondent: 15 hours.

Estimated Total Annual Burden Hours: 7,500.

Estimated Total Annualized Cost to the Public: N/A.

Dated: November 16, 1998.

J. Edgar Nichols,

Team Leader, Information Services Group.

[FR Doc. 98–31237 Filed 11–20–98; 8:45 am]

BILLING CODE 4820–02–P

INTRODUCTION

The financial stability and health of the companies in a holding company enterprise can have a direct impact on the financial condition of the subsidiary thrift. Holding companies are frequently managed on a consolidated basis with their subsidiaries. The benefits of such integration are key incentives for establishing a holding company. However, integrated operations may mean that one entity's problems become problems for other affiliated entities, including the thrift. Therefore, the purpose of this Section is to assist you in evaluating the financial performance and stability of the holding company enterprise, and evaluating the potential effect on the subsidiary thrift.

You will also need to determine whether the holding company has sufficient sources of funds other than from the thrift. A holding company does not have the access to insured deposits, or Federal Home Loan Bank advances, that a thrift has. Whereas liquidity driven failures are rare among insured depository institutions, cash flow difficulties can be a primary cause for a holding company financial collapse. As such, liquidity and cash flow ratio analysis are important factors to review for holding companies.

RISK PROFILE

As reiterated throughout this Handbook, the risk profile of a holding company enterprise is a major factor in the overall evaluation of a holding company. The financial condition and earnings performance of the companies in a holding company enterprise are key factors in assessing the risk profile. If, for example, you find that the holding company is entirely dependent on the subsidiary thrift for cash flow, the activities conducted within the enterprise, and corresponding funding needs, have a greater likelihood of being potentially detrimental to the thrift. As a holding company, or other affiliate is confronted with declining financial performance, it may do anything in its power to prevent failure. Therefore, you must be especially attentive in situations where the risk profile of the holding company enterprise creates an incentive for the thrift to engage in riskier activities or enter into transactions that are not in its best interest.

The actual, or pending, failure of an affiliate may also result in significant financial or operational distress for the thrift. For example, if a holding company pledges the common stock of the thrift as collateral for its debts, a default may result in a change of ownership control. Or, a thrift that is highly or completely reliant on an affiliate's customer base, or upon an affiliate for operational support, may not be able to operate on a stand-alone basis. Furthermore, a thrift could suffer reputational risk that tarnishes its good name as a result of actions taken by, or the financial condition of, its affiliates.

For all of these reasons, you should perform a detailed cash flow and financial analyses to identify emerging weaknesses and other situations where abuses might occur. Early detection will allow OTS to take preventive measures to insulate the thrift.

RATIO ANALYSIS – EARLY DETECTION

Certain financial ratios can help you identify a bankrupt or financially troubled company prior to the obvious presence of severe financial and legal problems. Ratio analysis provides a benchmark against which you can measure the relative profitability of the company compared to its peers and, tracked over time, it will identify trends and abnormalities that merit further analysis.

Calculate the following ratios to give you a snapshot of financial performance.

Cash Position: As the proportion of cash and marketable securities to total assets increases, the likelihood of failure declines – there is more cash available to pay immediate bills when they are due.

Current Ratio: As the proportion of current assets[1] to current liabilities[2] increases, the probability of failure declines – more assets can be converted to cash quickly relative to the liability repayments required within one year.

Operating Cash Flow: As the cash flow from operations (net income plus depreciation) increases, the likelihood of failure declines – there is more internal operating cash flow to meet long-term debt.

Debt Ratio: As the proportion of total liabilities to total assets increases, the probability of failure increases – larger portions of assets are financed by contractual sources of funds that necessitate fixed charges against income.

Double Leverage Ratio: Debt proceeds obtained from the holding company are invested in the thrift as equity. This increased capital base allows the thrift to increase its borrowings as well. Generally, as the double leverage ratio increases, so does the pressure on the thrift to maintain earnings to service both levels of debt, as often the parent relies on dividends from the thrift for its debt service requirements. Double leverage and how to measure it is further presented in the debt discussion of Section 300.

Return on Equity: As the net income to investors' equity increases, the likelihood of failure declines. Profitability is generally evaluated on a consolidated basis and will typically be expressed in terms of the return on equity (ROE). ROE[3] identifies the percentage of earnings management has generated on the capital invested into the business.

As mentioned above, ratio analysis involves two types of comparisons, trend and peer analysis. ***Trend analysis*** compares a present ratio with past and projected future ratios for the same company. The longer the period analyzed, the more meaningful the trend. ***Peer analysis*** compares the ratios of one company with another in the same industry at the same point in time. You must apply peer analysis judiciously, since holding companies are not a homogeneous group; it may be difficult to place a company into a relevant peer group. Also, peer data may not be prepared on a consistent basis due to individual reporting and accounting practices.

When using peer or trend analysis, you must carefully interpret the data. For example, a company may show an improving trend but still be very weak. Alternatively, a company may show better results than its peers in its industry, but still be weak because the industry overall is in very poor financial condition.

EARNINGS ADEQUACY

While ratio analysis can help you determine positive or negative financial trends, you must also analyze earnings adequacy and profitability. You must consider the following questions:

- What are the quality and level of earnings?
- Are nonrecurring sources of earnings relied upon?
- How does the volatility of earnings affect pro forma business plan projections?
- Are projections stress tested?

As you review the financial condition of a holding company enterprise, you must remain flexible. As noted throughout this Handbook, the specifics of each organizational structure will dictate your scope. The majority of thrift holding companies are shells. However, there are many OTS-regulated holding companies that are large busi-

[1] Current Assets = Cash or assets that have the ability to generate cash within one year.

[2] Current Liabilities = Liabilities that require payment within one year.

[3] As with any income measure, ROE must be looked at closely. The type of assets generating the profits, as well as the range of accounting assumptions should be considered. External factors often come into play, including pressure from Wall Street. Finally, be aware that the ROE can seem better than it really is if the company recently completed a stock buy-back (and reduced the amount of stock outstanding).

nesses. These holding companies may have a number of noninsured subsidiaries. These industries include securities broker/dealers, insurance underwriters and agents, manufacturing, and retail.

In the case of shell companies, thrift and holding company earnings will be almost identical, and parent only financial statements are appropriate. These holding companies do not engage in significant activities, and, in most cases, you will need to do little more than review the reasonableness of operating expenses and the dividend practices between the thrift and the parent.

For larger diversified operations, thrift earnings typically constitute only a small portion of the total and your analysis can concentrate on consolidated statements. However, to properly analyze consolidated profitability levels and trends, you should obtain a consolidating worksheet that both discloses, and explains, the intercompany accounts that have been eliminated. This will show each entity's contribution to total earnings.

For most nondiversified companies, fully consolidated data can be very misleading as the asset base and earnings of the thrift subsidiary will be large in relation to the consolidated total. Therefore, you will need to do a more in-depth analysis of other companies in the structure. Your analysis should focus on earnings trends and stability. You should identify extraordinary gains and losses that may mask weaknesses in the company's ability to maintain consistent profitability.

The best method to reasonably assess the risks to the thrift posed by its holding company and affiliates is to strip away the impact of the thrift from the financial statements. You can do this by obtaining or preparing statements that are fully consolidated as to the parent and all nonthrift affiliates. Such statements are necessary in order to properly understand the relative health of the nonthrift components within a holding company structure. On such statements the investment in the thrift will be but one line item on the balance sheet, and for earnings, one line item on the income statement. Looking at the financial statements in this manner will allow you to concentrate your analysis on results and trends not related to the thrift itself. If available, obtain the "parent company only" basis financial statements (required for SEC filers). These statements are also very useful when evaluating cash flow.

In addition to evaluating the level, source and volatility of earnings, you should analyze:

- Financial statements
- Credit ratings
- Stock price
- Business plans and budgets [4]
- Intercompany transactions[4]
- Cash flow.

Financial Statement Analysis

You can use internally and externally prepared financial statements and reports to evaluate the operations of companies in a holding company enterprise. The holding company's financial statements will provide insight into the financial demands placed on the thrift subsidiary, and the organization's overall strengths and weaknesses.

You should also review the minutes maintained for the audit committee to help identify any financial recordkeeping deficiencies disclosed to the directors by either the independent or internal auditors. You may also find information in the management letter prepared by the auditor, audit reports compiled by the internal auditor, or correspondence with the independent auditor.

Financial statements and supporting schedules should be complete, consistent, and accurate. Independent accountants are typically retained to provide assurance of the accuracy of financial statements prepared by management. You should carefully scrutinize unaudited financial statements

[4] Refer to Relationship Section 500 for more details.

or financial statements that have been assigned a qualified opinion. Similarly, you should investigate significant changes in financial statements or accounting systems.

Audited statements are typically only prepared annually, and are usually presented on a fully consolidated basis. This means that you will have to rely on internally prepared statements or general ledgers for interim periods. You should also be aware that in some cases, financial statements may be based on the regulatory accounting principles of another industry. Beginning in March 2001, thrifts in a holding company structure began reporting basic holding company financial information on the quarterly Thrift Financial Report. You should check the accuracy of the information reported on Schedule HC.

The following discussion highlights certain areas you should place particular emphasis on during your review of each financial statement.

Statement of Financial Condition

You should be particularly alert for affiliates engaged in high risk, cyclical, or off-balance sheet activities, that could adversely impact the company, causing additional pressures to be placed on the thrift. Such activities may include, for example, subprime lending, real estate investments or development, asset securitizations, venture capital funding, and volatile investment activities including derivatives, futures and options.

Distinguish between assets that provide liquidity and those that do not. For example, goodwill, and deferred tax assets are not liquid assets that can be relied upon to generate cash flow. A calculation of capital where these assets are deducted will give a truer sense of the real capital position of a holding company.

In addition, determine an investment's effect on liquidity. For example, leveraged instruments such as futures and options can be volatile and require cash. Commitments to other investments with material cash needs, include major construction projects and other capital-intensive businesses.

Finally, compare intercompany accounts (including investments in subsidiaries and due to or from subsidiaries) with corresponding accounts on the thrift or affiliate financial statements. This step is equally important for both stock and mutual holding companies.

Income Statement

Determine whether the business of companies within the holding company enterprise is cyclical. Focus on core earnings or income before extraordinary gains, as obviously extraordinary gains are not recurring. Pay particular attention to securitization revenue; the accounting rules are complicated and involve some subjectivity, as the calculations are assumption-driven. Unreasonable assumptions have led a number of financial institutions to misstate securitization gains.

Credit Ratings

Analysis of a holding company's financial statements may be supplemented by the market price (yield) and the credit rating of its debt. Bonds issued by holding companies with high yields, relative to U.S. Treasury Bonds, or low grades, may pose additional risks.

The principal rating services include Moody's Investors Services, Standard & Poors, Fitch Investor Service, Inc., and Duff and Phelps. A rating is not a recommendation to purchase, sell, or hold a security. The rating provides an unbiased assessment of the perceived creditworthiness of a debtor for a specific security. Generally, the ratings have been accurate; that is, low-grade bonds default more frequently than high-grade securities. However, these ratings are not infallible, as sudden changes in market conditions have led to even investment grade issues filing for bankruptcy. Also, issuers with a good rating may find that their ratings decline. You should identify whether a holding company's bonds have been rated, and if so, are subject to a downgrade. Typically, the first indication to the public that weaknesses are emerging is a rating downgrade, but ratings changes tend to lag actual credit deterioration. Often, the market price of the bond is adjusted before the rating agencies have a chance

to react. Therefore, market prices should also be considered.

Closely evaluate the financial condition of any holding company whose securities are rated below investment grade. The following **Summary of Rating Categories** identifies the range of letter grades used by the two major rating agencies. An investment grade bond includes the top four categories (for example, AAA to BBB).

Summary of Rating Categories

Credit Rating	***MOODY'S***
Aaa	Strongest Creditworthiness
Aa	Very Strong Creditworthiness
A	Above-average Creditworthiness
Baa	Average Creditworthiness
Ba	Below-average Creditworthiness
B	Weak Creditworthiness
Caa	Speculative, Very Weak Creditworthiness, May be in Default
Ca	Highly Speculative, Extremely Weak Creditworthiness, Often in Default
C	Extremely Speculative, Weakest Creditworthiness, Usually in Default
Credit Rating	***Standard & Poors***
AAA	Extremely Strong
AA	Very Strong
A	Strong
BBB	Adequate
BB	Speculative Characteristics - Less Vulnerable
B	Speculative Characteristics - More Vulnerable
CCC	Speculative Characteristics - Currently Vulnerable
CC	Speculative Characteristics - Currently Highly Vulnerable
C	Currently Highly Vulnerable to Nonpayment
DDD-D	In Default, Rating Indicates Likely Salvage

A low-grade or a declining rating should serve as an alert to consider expanding your scope to better determine the holding company's financial capacity and capital position.

Stock Prices

You may also obtain early warning of a holding company's weakening financial condition by evaluating the trend of its stock prices. Stock prices reflect the perceptions of investors as they evaluate the risk and return profile of a company. However, during periods of high market volatility, changes in stock prices may be more reflective of concerns within a particular industry or the overall market, rather than a specific company. Key ratios for publicly traded companies include:

Market Value/Book Value: The ratio of the combined market price of outstanding stock to the accounting book value. You can compare the company's ratio to those of its peers, with higher ratios indicative of greater investor confidence in the company's prospects[5]. A favorable market perception generally allows a company to raise capital at an attractive price.

Price/Earnings: The ratio of the price of stock to the prior 12-month earnings. Ratios above market averages reflect expectations of future growth while ratios below market averages reflect uncertainty or less growth.

A holding company should command a higher *Market/Book* or *P/E ratio*, if its ROE exceeds its peers. In addition, a holding company should command a higher *Market/Book* or *P/E ratio* if the ROE exceeds the investors' required return, which is based on risk. This return is an opportunity cost and is sometimes called cost of equity (COE). Further, the market/book ratio should increase as the ROE/COE spread increases above one.

[5] See Monitoring section for more details.

CASH FLOW

Profitability is an important measure of financial strength and managerial efficiency. However, ultimately a company's ability to generate cash flow will determine whether or not it will be able to meet its fixed obligations, such as debt service and preferred stock dividends, as well as fund dividends to common stockholders from internal operations. You should consider the following questions:

- To what extent does the holding company rely on dividends from the thrift to service holding company debt or fulfill other obligations?
- What sources of liquidity, other than the thrift, does the holding company have?
- What are the quality and quantity of such sources?

The purpose of the cash flow statement is to summarize financing and investing activities and to identify whether funds are being generated from internal or external sources. Generally, audited financial statements provide "parent company only" financial information, which includes a Statement of Cash Flows. The cash flow statement can be used for more than just determining whether or not the company maintains positive cash flow. It can also identify how the company obtains and allocates its funds. Most importantly, this statement can be used to identify and quantify the funds that are provided directly by the thrift, and to what degree the parent relies upon those funds to maintain its operations.

Funds provided by a thrift subsidiary typically take the form of dividends, management fees, expense reimbursements, and tax sharing payments. Ascertain the extent of reliance the holding company places on the thrift by considering the:

- Portion of cash flow from operating and investing activities that is supplied from the thrift subsidiary; and
- Amount of interest expense on parent company borrowings that is paid from thrift subsidiary dividends.

Concentrate on assessing or identifying any operational weaknesses, which could result in the holding company requiring funding from the thrift. In situations where the parent is financially distressed, determine whether the financial condition is linked with the thrift reorienting its business practices towards higher risk activities, or even liquidating assets, to generate support required by the parent.

From time-to-time, all businesses will be confronted with cash flow or funding shortfalls as a normal result of doing business. Your concern should be in determining whether such shortfalls are temporary, or indicative of an overall decline in financial health, and what sources are available to the parent to make up for the deficit. A company can raise cash by:

- Liquidating/selling assets,
- Issuing stock,
- Increasing borrowings,
- Requiring repayment of advances to its subsidiaries, and
- Requiring additional payments of dividends or other cash payments from subsidiaries.

Such sources can only temporarily alleviate the effects of a shortfall, and you must look beyond such events to assess future cash flow needs. Selling income-generating assets will reduce future earnings, and issuing additional debt or equity will increase future funding requirements in the form of debt service or dividend payments. While companies commonly use short-term debt to fund deficit cash flow, this practice may jeopardize its long-term liquidity and earnings by increasing liabilities and related interest costs without a corresponding increase in earning assets. To the extent that systemic funding imbalances are expected to persist, you should comment in the examination report.

To assess the holding company's ability to meet its contractual obligations from current earnings, you should compute the *Fixed Charge Coverage Ratio* which is defined as the parent only after tax

cash income plus interest, lease and rental expenses, divided by fixed contractual obligations, as follows:

Fixed Charge Coverage Ratio:

$$\frac{\text{After tax cash income + interest, lease, and rental expense}}{\text{Interest, lease, and rental expense + contractual long-term debt retired + preferred stock dividend payments}}$$

In general, if this ratio is below 1:1, the company is not generating sufficient internal funds to cover its contractual obligations, much less any dividends to common stockholders, and is cause for concern. Even a ratio that is only slightly greater than 1:1 may be barely adequate and may be a concern if the current level results from a deteriorating trend. Also, keep in mind that in many nondiversified holding company structures, the primary source of cash income will be dividends paid by the thrift to the parent. Any dividend restrictions placed on the thrift will substantially impact the results of this analysis. Furthermore, as noted numerous times above, directed changes to thrift operating practices designed to increase thrift earnings can adversely affect the overall safe and sound condition of the thrift.

Liquidity

Cash flow is generally defined as the ability to obtain and allocate cash. Liquidity is defined as a company's ability to meet its short-term obligations either through cash on-hand, converting existing assets to cash, or rolling over maturing debt. Generally, short term is viewed as periods of up to a year. Liquidity problems will typically fall within a broad range of severity. On one hand, temporary liquidity problems may mean that a company is unable to take advantage of an immediate desirable business opportunity. Conversely, severe liquidity shortfalls may mean that a company is unable to meet short-term obligations and may be in a position of having to default on its debt obligations. As a worst case, this could result in bankruptcy.

In your financial analysis, you should review the contractual maturity structure of the holding company's assets and liabilities. In cases where liquidity concerns are evident, or emerging, you should develop a maturity matching schedule comparing contractual maturities of assets and liabilities over the near term (up to 90 days), short term (91 days to one year), and long term (over one year). You must also take into account the degree to which funding is reliant upon the recovery of advances to subsidiaries, which themselves may be illiquid. Also, you need to consider whether assets can be sold and converted to cash without incurring substantial loss on the sale.

To the extent that your analysis shows a material imbalance of maturing debt instruments compared to reasonably available resources, you should discuss this with management to determine how they intend to handle the shortfall. This should also be incorporated into the cash flow analysis and discussed in the examination report.

RATING THE EARNINGS COMPOMENT

You will assess the holding company enterprise's risk profile and evaluate the adequacy of earnings on a case-by-case basis. To do so, consider, among other things, profitability, business plans and budgets, peer comparisons, credit ratings, stock price, and cash flow.

You should assign an ***earnings component rating of "1"*** when operating performance and profitability are above average. Cash flow is routine and sufficient, especially relative to the businesses conducted. Financial indicators equal or exceed forecasted performance.

You should assign an ***earnings component rating of "2"*** when earning results are comparable to peers with cash flow sufficient to meet debt service.

You should assign an ***earnings component rating of "3"*** when operating performance is poor or below average, with no expectation of improvement. These companies may be experiencing losses or erratic performance, have insufficient cash flow

to meet debt service, and are largely dependent on the thrift subsidiary.

SUMMARY

Profitability is but one of a number of critical factors considered in the regulation of a thrift holding company enterprise. However, profitability must be evaluated in conjunction with a number of other factors.

Financial strengths and weaknesses can be measured by a variety of ratios and market indicators. The holding company and its subsidiaries, including the thrift are often managed on a consolidated basis. While such integration provides advantages to both the thrift and the holding company, there are also potential pitfalls.

Program Guidance: Examiners should complete only those sections of the program that the EIC deems necessary to evaluate this area and to support the overall examination conclusions.

Examination Objective

To ensure that the scope of the examination of the holding company structure is appropriate to adequately assess the risks presented.

Wkp. Ref.

Preexamination Procedures

1. Determine if any entity in the holding company structure is functionally regulated by the SEC, CFTC or various state insurance agencies. If so, you must consider the additional "Functionally Regulated" procedures which are italicized in the program. Also, note the functionally regulated entity and its primary regulator in the Regulatory Profile System, as well as the address and phone number of a contact person responsible for its supervision.

   [Click&type] [Click&type]

2. Forward the PERK to the top-tier holding company approximately one month prior to the joint examination of the "lead" association and the holding company. (In certain situations it may be appropriate to forward the PERK to another tier in the complex; however, in most cases, the top tier will be the starting point for a holding company examination.)

   Functionally Regulated-Review the PERK to determine if any of the information request can be supplied by reports submitted to other regulators. After ensuring that the PERK does not request duplicative or publicly available information, direct any information requests that apply to a functionally regulated entity to that entity's other regulator approximately six weeks prior to the examination of the lead association. Request the other regulatory body to gather the information and return it to the regional office.

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Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

3. Review the institution overview in the regulatory profile system. (The institution overview can be found in the electronic continuing examination file (ECEF) on the OTS intranet). Verify the accuracy of the structure data in the holding company enterprise summary. Make any noted corrections to the structural data prior to creating an examination shell. (If you need to correct structure data after the shell is created, you must delete the shell, create the new shell, and inform the TARS administrator to bill hours to the new exam.)

   [Click&type] [Click&type]

4. Perform preexamination/scoping analysis. (Suggested scoping materials below.)
   - Reports submitted to the OTS (H-(b)11 Annual/Current Report, H-(b)10 Registration Statement).
   - Reports filed with the Securities and Exchange Commission (submitted as attachments to the H-(b)11).
   - Statements of financial condition and operations.
   - Most recent audit reports (including the Management Representation letter to the external auditor detailing pending and threatened litigation that may have a material effect on the holding company).
   - Previous OTS examination report and supporting workpapers.
   - Supervisory correspondence.
   - Recent applications, including conditions of approval.
   - Examination reports from other regulatory agencies, including self-regulatory bodies such as NASD.
   - Other correspondence and data supplied by other regulators.
   - Public sources: credit ratings by major rating agencies, newspaper or magazine articles, Reuters/AP internet reports.
   - Holding company and affiliate web sites.
   - Holding company board minutes.
   - PERK.
   - Subsidiary thrift's regulatory profile.

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Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

5. Re-evaluate the holding company categorization by considering the questions in the Risk Classification Checklist to identify higher risk factors.

   [Click&type] [Click&type]

Examination Procedures-Overall Guidance

(For detailed procedures on component areas, see Sections 720 or 730)

6. Verify compliance with supervisory directives and enforcements actions.
   - Verify compliance with:
     - Conditions of approval
     - Outstanding enforcement actions
     - Supervisory agreements and directives.
   - Verify correction of violations or exceptions from previous examination.

   Functionally Regulated-Coordinate findings and recommended actions with any regulator that has an interest.

   [Click&type] [Click&type]

Postexamination Procedures

7. Prepare examination report.

   [Click&type] [Click&type]

8. Assign overall rating to the holding company complex.

   [Click&type] [Click&type]

9. Conduct meeting with board of directors or senior management to review examination findings.

   Functionally Regulated - Coordinate with the other regulators on all such meetings. Invite other functional regulators of the holding company to participate.

   [Click&type] [Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

10. Complete all Holding Company Examination Data System entries.

    [Click&type] [Click&type]

11. Update and make corrections as appropriate to Regulatory Profile System and other OTS databases.

    [Click&type] [Click&type]

12. Transmit examination report to the holding company.

    Functionally Regulated - You should follow the information sharing procedures outlined in the agreements OTS has executed with the primary regulators of functionally regulated affiliates. As a general rule, copies of the examination report and any other confidential information will be provided to the functionally regulated entity's primary regulator upon receipt of a written request that demonstrates a justifiable need for the information. You should coordinate with your region's functional regulation contact.

    [Click&type] [Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Risk Classification Checklist

In answering these questions, you should interpret the term "holding company" broadly, so as to include all affiliates within a holding company family.

DETERMINING LOW RISK/NONCOMPLEX SHELL HOLDING COMPANIES

	Yes	No
a) Is the holding company a shell? If Yes, go to Question b. If no, skip to Question e in the next section.	[Click&type]	[Click&type]
b) Is the shell only engaged in investing cash from dividends or proceeds from stock sales? If Yes, go to Question c. If no, skip to Question e in the next section.	[Click&type]	[Click&type]
c) Does the shell have only minimal debt that can easily be serviced by its own resources? If Yes, go to Question d. If no, skip to Question e in the next section.	[Click&type]	[Click&type]
d) In its cash management, does the shell invest solely in US government securities or other liquid nonleveraged cash instruments such as bankers acceptances or high grade commercial debt, or does it invest in high risk, highly leveraged instruments like options or futures that could lead to significant cash flow needs?		
— Liquid interest bearing instruments	[Click&type]	[Click&type]
— Highly leveraged instruments	[Click&type]	[Click&type]

If you answered "Yes" to questions a, b, and c, and the answer to question d is liquid interest bearing instruments GO NO FURTHER. The holding company you are reviewing is a low risk, noncomplex shell. You do not need to complete the remainder of this checklist. Refer to the Abbreviated Holding Company Examination Program, Section 720.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

	Yes	No
If the answer is highly leveraged interest bearing instruments, please continue. These holding companies and all other nonshell holding companies present at least a moderate risk. The remaining questions will help you determine the nature of those risks. A YES answer to any of the following questions could indicate that the holding company is complex and may present a higher than normal degree of risk. You should weigh the importance of each question based on the holding company's specific circumstances.		
FINANCIAL CONDITION		
e) Does the holding company lack a consistent source of reliable cash flow and stable earnings from operations other than proceeds from the thrift?		
If Yes, review Earnings section of Program 730	[Click&type]	[Click&type]
f) Is the holding company significantly leveraged, either with high debt levels, other hybrid instruments with debt-like features, or highly volatile investments, such as futures, options, IOs, or residuals?		
If Yes, review Capital and Earnings sections of Program 730	[Click&type]	[Click&type]
g) Does the holding company have major investments that can rapidly require significant cash expenditures, such as futures, short options or financing construction?		
If Yes, review Capital and Earnings sections of Program 730	[Click&type]	[Click&type]
h) Even if the holding company currently has low levels of debt and conservative investments, is it in a cyclical industry that is distressed or clearly experiencing adverse trends?		
If Yes, review Capital section of Program 730	[Click&type]	[Click&type]
i) Does the holding company have a history of volatile operating earnings?		
If Yes, review Earnings section of Program 730	[Click&type]	[Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

	Yes	No
j) Has the holding company or any of its affiliates recently had a downgrade in debt ratings by a major debt rating agency, such as Moody's or Standard and Poor's?		
If yes, review Capital section of Program 730	[Click&type]	[Click&type]
FINANCIAL INDEPENDENCE		
k) Is the thrift dependent on the holding company for access to the capital markets?		
If Yes, review Capital section of Program 730	[Click&type]	[Click&type]
l) Is the thrift unlikely to survive the financial collapse of the holding company or a major affiliate?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]
OPERATIONAL INDEPENDENCE		
m) Do the thrift's management and BOD consistently act in a manner beholden to the holding company?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]
n) Are the thrift's operational systems dependent upon the holding company or any of its affiliates?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]
o) Is the *thrift* basically a "shell" with no or few full time employees dedicated only to the thrift's well-being, as opposed to having a distinct management team devoted to the thrift?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]
p) Are the thrift's audit functions consolidated within the holding company, as opposed to having a separate, distinct audit department?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

	Yes	No
q) Are most, if not all, key functions of the thrift, such as risk management, underwriting, investment advice, trading, and other banking or lending functions, being performed by the holding company or any of its affiliates?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]
r) Is the compensation of thrift employees, either directly or indirectly through stock options, tied to the performance of the holding company?		
If Yes, review Relationship section of Program 730, and review Thrift Activities Handbook Section 330.	[Click&type]	[Click&type]
s) Are there significant or abusive intercompany or insider transactions such as loans, guarantees, asset purchases/sales, or service contracts?		
If Yes, review Relationship section of Program 730, and review Thrift Activities Handbook Section 380.	[Click&type]	[Click&type]
REPUTATION RISK		
t) Is the thrift's public identity linked with the holding company, such as a similar name and marketing strategies?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]
u) Is there significant cross-selling of proprietary products, like trusts, insurance policies, mutual funds and the like?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]
v) Is the thrift limited purpose in that it serves only to facilitate the sale of services and products of the holding company, for example trusts or mutual funds, as opposed to being a full service community association?		
If Yes, review Organizational Structure section of Program 730	[Click&type]	[Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

	Yes	No
w) Do virtually all the thrift's assets or liabilities come, directly or indirectly, from the holding company or any of its affiliates, as opposed to a widely diverse community deposit base with independent franchise value?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]
MANAGEMENT EXPERIENCE		
x) Is the holding company inexperienced in running a federally insured entity, as opposed to a history of managing banks and thrifts?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]
y) Is the thrift a de novo, as opposed to a thrift with existing management that has a proven track record?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]
z) Is the holding company itself relatively new, as opposed to a well established business with many years of successful operations?		
If Yes, review Relationship section of Program 730	[Click&type]	[Click&type]
aa) Is the holding company in a significantly different business than financial services, such as manufacturing, with different auditing and accounting practices?		
If Yes, review Capital and Earnings sections of Program 730	[Click&type]	[Click&type]

HOLDING COMPANY CLASSIFICATION

After completing the checklist, check the appropriate holding company categorization below. There is no hard and fast rule that indicates how many Yes answers are needed to deem a holding company as Category II. For instance, even if the thrift has its own distinct existence, staff and systems, a Yes answer to questions "e" through "j" could lead to determining that the holding company is complex, since the holding company's financial condition means there is a greater incentive to try to boost earnings or cash flow via the thrift.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

You must make considered judgments as to the current and prospective risks that a holding company poses to its insured subsidiary. In general, if the thrift does have substantial insured deposits from outside the holding company, but is predominately beholden to the holding company for operational support, you should consider it Category II and focus heavily on the relevant procedures cross-referenced in the checklist. In such a case, a failure of the holding company would lead to the failure of the thrift.

You also need to consider consumer issues as well. Even if the thrift has virtually no insured deposits, making the prospect of a loss to the insurance fund unlikely, you still need to ensure the thrift is operating in a manner that it can survive the collapse of its parent. Even if no insured deposits are at risk, consumer *assets*, such as trusts, will be at risk if the thrift fails due to financial distress at its parent. Although nothing can be done to protect customers from market losses due to declines in the stock, bond or real estate markets, the thrift should still be able to ensure that the actual trust *accounts* are managed in an appropriate manner should the holding company fail.

Thus, even in those cases where the thrift has independent management, systems and identity, you should still consider it Category II if it is financially troubled. Similarly, <u>any holding company with an unsatisfactory "U" rating should be classified as Category II</u>. Although we have successfully insulated insured institutions from the bankruptcy of its parent, it is a difficult and time consuming process. Regional staff must be on alert whenever a holding company suffers crippling financial reverses.

(Please Check One)

The Holding Company is Noncomplex and not High Risk - Category I [Click&type]

The Holding Company is Complex or somewhat Higher Risk - Category II [Click&type]

Summarize the basis for your conclusion in your workpapers.

Examiner's Summary, Recommendations, and Comments

[Click & type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Program Guidance: This Abbreviated Holding Company Examination Program should be used to examine low risk or noncomplex holding company enterprises. Also, be sure to consider the unique characteristics of the specialized holding company structures discussed in Section 900. You should complete only those sections of the program that the EIC deems necessary to evaluate each CORE examination area and to support the overall examination conclusions. You may consult the full CORE Holding Company Examination Program (Section 730) for more detailed steps for each procedure.

C – Capital

Examination Objectives

Determine the holding company's financial resources and assess its current and prospective effect on the subsidiary thrift.

Evaluate the holding company's level of debt and capital structure.

Examination Procedures

Wkp. Ref.

1. Assess the holding company's ability to service its outstanding debt and the degree the thrift is relied upon to upstream funds to service the debt. Determine whether double leveraging is occurring, and to what extent.

   [Click&type] [Click&type]

2. Assess the holding company's consolidated capital structure. Consider the quantity and composition of capital. Does the holding company have enough capital to protect the subsidiary thrift from risky activities or adverse events within the holding company enterprise?

   [Click&type] [Click&type]

3. Consider the effect of the company's dividend practices on its capital condition.

   [Click&type] [Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

4. For affiliates that are regulated by another state or federal agency, determine if there are any agreements or conditions imposed that would require the holding company to devote financial resources (such as capital contributions) to that entity. If such an agreement exists, determine the extent to which it could ultimately have an adverse impact on the subsidiary thrift.

   [Click&type] [Click&type]

O – Organization Structure

Examination Objectives

Analyze ownership and control.

Determine if there is evidence that the holding company structure is designed to circumvent OTS policies.

Identify activities of the holding company and its noninsured subsidiaries to determine permissibility.

Assess what risks the activities of the holding company and its other affiliates pose to the thrift.

5. Analyze changes in the holding company's organizational structure since acquisition or the previous examination. Obtain or prepare an organizational chart that identifies all holding company tiers and other affiliates of the thrift.

   [Click&type] [Click&type]

6. Determine whether any individual or entity – directly, indirectly, or by acting in concert – has acquired control.

   [Click&type] [Click&type]

7. Evaluate the risk that the activities of the holding company or other affiliates pose to the subsidiary thrift.

   [Click&type] [Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

R – Relationship

Examination Objectives

Assess the influence of the board of directors and management on the thrift.

Consider how integrated the thrift is in the holding company enterprise.

Consider the independence of the boards of directors of the thrift, holding company and other affiliates.

Determine if intercompany transactions are appropriate.

Examination Procedures

8. Assess the influence of the board of directors and management on the thrift. Consider the independence of the boards of directors of the thrift, holding company and other affiliates. Do any relationships appear to create a conflict of interest or usurpation of corporate opportunity?

   [Click&type] [Click&type]

9. Review management's written strategic goals and objectives. Evaluate whether the organization's goals have changed, and, if so, assess how they affect the risk-profile and financial condition of the company.

   [Click&type] [Click&type]

10. Assess the adequacy of internal controls, books, records and systems to ensure that the thrift maintains separate corporate identity.

    [Click&type] [Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

11. Determine the extent to which the operations of the thrift are integrated with the holding company and other affiliates. Assess the risks posed by integrated systems, common risk management practices, central decision making, joint marketing and delivery systems, linked market reputation, and the significance of the thrift within the structure. Evaluate whether the thrift can be insulated from adverse events within the holding company structure and carved out as a stand-alone operating entity.

    [Click&type] [Click&type]

12. Analyze the tax-sharing agreement and policies, tax payments paid by the subsidiary association to the holding company, and the income tax accounting and settlement practices where the thrift does not file a separate tax return.

    [Click&type] [Click&type]

13. Identify and assess the direct and indirect impact on the thrift of any significant intercompany or insider transactions such as asset purchases/sales, contracts for services, loans, or guarantees. If the transactions were conducted with the thrift, ensure that they were properly identified in the thrift's books and records and reviewed for compliance with the affiliate transaction regulations (12 CFR 563.41 and 563.42).

    [Click&type] [Click&type]

14. Verify compliance with statutory and regulatory requirements.

    [Click&type] [Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

E – Earnings and Liquidity

Examination Objectives

Assess the trends of the holding company's earnings and cash flows.

Determine if the holding company's earnings and cash flow trends may lead it to require the thrift to provide funds through dividends or other means.

Examination Procedures

15. Review the holding company's financial statements, consolidated audit, management representation letter, and SEC filings. Identify financial trends, discussions of significant accounting practices and any material weaknesses identified in the most recent independent audit report, prior examination reports of OTS or any other regulator. Determine the relative strength of subsidiaries to holding company profitability and balance sheet strength.

    [Click&type] [Click&type]

16. Identify any changes to the bond ratings of the holding company or significant affiliates. Assess the causes for any changes.

    [Click&type] [Click&type]

Examiner's Summary, Recommendations, and Comments

[Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Program Guidance: This CORE Holding Company Program should be used to examine high risk or complex holding company enterprises. Also, be sure to consider the unique characteristics of the specialized holding company structures discussed in Section 900. This Program may also be used to supplement the Abbreviated Holding Company Examination Program (Section 720). You should complete only those sections of the program that the EIC deems necessary to evaluate each CORE examination area and to support the overall examination conclusions.

C – Capital

Examination Objectives

Determine the holding company's financial resources and assess its current and prospective effect on the subsidiary thrift.

Evaluate the holding company's level of debt and capital structure.

Examination Procedures

Wkp. Ref.

1. Assess the holding company's ability to service its outstanding debt and the degree the thrift is relied upon to upstream funds to service the debt. Determine whether double leveraging is occurring, and to what extent.

   - Determine if the level of consolidated debt is increasing and if interest expense is a significant portion of recurring income.
   - Calculate the ratio of ***consolidated holding company debt to consolidated tangible capital***. (For holding companies with significant nonthrift operations, particularly in industries with large investments in fixed assets, calculate the ***debt-to-total asset*** ratio.)
   - Calculate the holding company's ***leverage*** ratio.
   - Compute the ***debt-to-equity*** ratio on a market value and book value basis to assess the market perception of the company.
   - Consider if the holding company is investing in leveraged instruments such as futures and options that can require volatile cash needs.
   - Determine to what degree the holding company has retained recourse (explicit or implicit) related to off-balance sheet funding activities such as asset securitizations.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

- Consider whether the holding company is committed to investments with material cash needs, such as major construction projects and other capital intensive business activities.

[Click&type] [Click&type]

2. Assess the holding company's consolidated capital structure. Consider the quantity and composition of capital. Does the holding company have enough capital to adequately protect the subsidiary thrift from risky activities or adverse events within the holding company enterprise? Consider the overall risk profile and all risk factors, including credit, market, operational, and legal risks.

- Determine if the holding company's capital position has deteriorated since the last examination. If so, cite the reasons.
- Analyze whether the holding company has significantly restructured its asset/liability portfolio or made significant acquisitions or divestitures.
- Review the composition of consolidated capital. How would capital be affected if thrift capital conventions, bank holding company capital conventions, or the capital conventions of other functional regulators are applied?
- Consider the extent to which the holding company uses debt-like instruments such as trust preferred stock for financing. Determine if management developed a sound plan for investing the proceeds of any such financing activities. Determine how interest or dividend obligations are financed, specifically, if the thrift is relied upon, in whole or in part, to service such obligations?
- Review the holding company's capital plans. Consider the effect of future transactions and major acquisitions on capital. Assess the holding company's access to capital markets.
- In cases where capital is considered inadequate, discuss with management any plans to access the capital markets or otherwise augment capital.

[Click&type] [Click&type]

3. Consider the effect of the company's dividend practices on its capital condition.

- Identify situations where the company or thrift must borrow funds or sell assets to maintain dividend payments.
- Calculate the holding company's ***dividend payout to earnings*** ratio and determine if it is consistent with the business plan.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

- Compare the dividend payout ratios, net income, and asset size of significant affiliates to assess relative contributions.

[Click&type] [Click&type]

4. For affiliates that are regulated by another state or federal agency, determine if there are any agreements or conditions imposed that would require the holding company to devote financial resources (such as capital contributions) to that entity. If such an agreement exists, determine the extent to which it could ultimately have an adverse impact on the subsidiary thrift.

[Click&type] [Click&type]

O – Organizational Structure

Examination Objectives

Analyze ownership and control.

Determine if there is evidence that the holding company structure is designed to circumvent OTS policies.

Identify activities of the holding company and its noninsured subsidiaries to determine permissibility.

Assess what risks the activities of the holding company and its other affiliates pose to the thrift.

Examination Procedures

5. Analyze changes in the holding company enterprise since acquisition or the previous examination.

   Compare the current organization chart with one at the time of acquisition or the previous examination.

   - Review organizational data provided by any other regulatory agency.
   - Identify all tiers of the holding company. Ensure that the OTS holding company database accurately reflects the current structure.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

- Determine if the holding company has acquired, formed, divested, or transferred any subsidiaries or significant portion of its consolidated assets.

[Click&type] [Click&type]

6. Determine whether any individual or entity - directly, indirectly, or by acting in concert - has acquired control.

- Review a list of all significant shareholders to determine the number of shares owned and percentage of outstanding stock held. (Significant stockholders include any person or entity that owns ten percent or more of stock either individually or acting in concert.)
- Determine whether any changes in ownership have occurred since acquisition or previous examination.
- Determine whether the holding company repurchased a significant amount of its stock or if any new issuances of capital stock, capital notes, or subordinated debentures occurred.
- Consider exemptions contained in Section 10(a) of the Home Owners' Loan Act and 12 CFR Section 574.3.

[Click&type] [Click&type]

7. Review the activities of the holding company and other affiliates.

- Evaluate the risk that the activities of the holding company or other affiliates pose to the thrift.
- Ensure that the holding company is not engaged in any acts or acquisitions prohibited by 12 CFR 584.4 or 584.9 regarding ownership interests in nonaffiliated companies or control of mutual thrifts, respectively.

[Click&type] [Click&type]

R – Relationship

Examination Objectives

Assess the influence of the board of directors and management on the thrift.

Consider how integrated the thrift is in the holding company enterprise.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

Consider the independence of the boards of directors of the thrift, holding company and other affiliates.

Determine if intercompany and insider transactions are appropriate.

Examination Procedures

8. Assess the influence of the board of directors and management on the thrift. Consider the independence of the boards of directors of the thrift, holding company, and other affiliates. Determine whether any of the relationships appear to create a conflict of interest or usurpation of corporate opportunity.

   - Identify the principal decision makers of the holding company, including major shareholders. Does the holding company share common officers with the thrift? If so, expand your review in the thrift examination to ensure they are fulfilling their fiduciary role to the thrift.
   - Does the holding company have policies and procedures regarding conflicts of interest and intercompany and insider transactions. Evaluate whether such policies are adequate to protect the interests of the thrift and are being followed.
   - Determine the thrift's line of reporting to the holding company.

   [Click&type] [Click&type]

9. Review management's written strategic goals and objectives. Evaluate whether the organization's goals have changed, and, if so, assess how they affect the risk-profile and financial condition of the company.

   [Click&type] [Click&type]

10. Assess the adequacy of internal controls, books, records and systems to ensure that the thrift maintains separate corporate identity.

    - Determine whether the financial statements are complete, consistent, and accurate. Consider the materiality of the thrift to the overall corporate structure and the scope of the independent audit. Resolve any discrepancies.

      Functionally Regulated-Determine if any discrepancies are due to different forms of regulatory accounting practices.

    - Identify who performs the audit of the holding company and the thrift and whether there has been a change in auditing firms and the reason for such change.
    - Identify who performs the internal audit work for the holding company and determine whether independence requirements have been met.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

- Determine the effect of accounting changes to the financial recordkeeping and reporting processes.
- Review the audit committee minutes and any correspondence between the holding company and the independent auditor to identify financial recordkeeping deficiencies disclosed to the directors.
- Identify any recommendations, criticisms, or comments related to financial recordkeeping and reporting in the most recent independent audit report and prior examination reports of OTS and any other regulatory agency.

[Click&type] [Click&type]

11. Determine the extent to which the operations of the thrift are integrated with the holding company and other affiliates.

- Assess the risk posed by integrated systems, common risk management practices, central decision making, joint marketing and delivery systems, linked market reputation, size of the thrift in relation to the holding company, and common controls.
- Assess the risk posed by the thrift's public identity being linked with the holding company. In particular, review the Management Representation letter, or an attached attorney's letter, to the external auditor detailing pending or threatened litigation that could harm the holding company, and pose reputational risks for the thrift.
- Evaluate whether the thrift can be insulated from adverse events within the holding company structure and carved out as a stand-alone operating entity, if necessary. Ensure that separate corporate identity is maintained.
- Review policies and procedures concerning the operation of the association.
- Review any plans for the thrift.

[Click&type] [Click&type]

12. Identify and assess the direct and indirect impact on the thrift of any significant inter-company or insider transactions such as loans, guarantees, asset purchases/sales or service contracts. If the transaction is with the thrift, ensure that it is properly reflected in the thrift's books and records and reviewed for compliance with the affiliate transaction regulations (12 CFR 563.41 and 563.42).

[Click&type] [Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

13. Analyze the tax-sharing agreement and policies, tax payments paid by the thrift to the holding company, and the income tax accounting and settlement practices where the thrift does not file a separate tax return.

- Determine whether the agreement conforms to the OTS policy, particularly with regard to timing, amount, refunds, and treatment of deferred taxes.
- Determine whether the agreement is governing the current practices of the consolidated group.
- Determine that taxes collected by the parent holding company from the thrift are not in excess of the amount that the thrift would have paid if it had filed a separate return.
- Determine that tax payments made by the thrift do not significantly precede the time that a consolidated estimated tax liability would be due and payable by the holding company to the taxing authorities.
- Determine that the amount and timing of payment of taxes and receipt of refunds by the thrift is no less favorable to the thrift than if it had filed separate returns or made separate estimated payments to the taxing authority.
- Determine that the deferred tax accounts of the thrift are maintained on its own books and are not transferred to the books of the holding company.
- Determine if the Internal Revenue Service (IRS) or other taxing authorities have assessed any additional tax payments on the consolidated group.
- Determine that the holding company has allocated any such additional assessments in accordance with the tax-sharing agreement.
- If there is a conflict between the tax sharing policies of OTS and the policies of another regulatory agency, contact regional management.
- Analyze the income tax accounting and settlement practices where the thrift does not file a separate tax return.
- Review consolidating schedules supporting financial reporting and determine the reasonableness of income tax expense (benefit) to the thrift compared with other members of the group. Timing differences between book income and taxable income may affect the analysis.
- Determine if any IRS examinations are ongoing and whether any material additional tax obligations are anticipated as a result.
- Determine if there are outstanding refunds from amended or net operating loss carrybacks that should be allocated to the thrift, or filings of questionable

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

recoverability (from the holding company) that could result in chargebacks to the thrift.

[Click&type] [Click&type]

14. Verify compliance with statutory and regulatory requirements.

[Click&type] [Click&type]

E – Earnings

Examination Objectives

Assess the trends of the holding company's earnings and cash flows.

Determine if the holding company's earnings and cash flow trends may lead it to require the thrift to provide funds through dividends or other means.

Examination Procedures

15. Review the holding company's financial statements, consolidated audit, management representation letter, and SEC filings. Identify financial trends, discussions of significant accounting practices and any material weaknesses identified in the most recent independent audit report, prior examination reports of OTS or any other regulator.

[Click&type] [Click&type]

16. Determine the relative strength of subsidiaries to holding company profitability and balance sheet strength.

- Calculate the following ratios to identify financial trends: cash position, current ratio, operating cash flow, debt ratio and return on equity.
- Using trend and peer analysis, evaluate the earnings of the company's nonthrift operations/subsidiaries over the prior three years and determine the causes for weak or deteriorating performance.
- Evaluate the quality of earnings. Determine whether the sources of earnings of pre-tax income are recurring.
- Assess whether the holding company is in a highly cyclical business.

[Click&type] [Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

17. Use external information to evaluate holding company's financial condition.

    - Identify any changes to the bond ratings of the holding company or significant affiliates. Assess the causes for any changes.
    - Determine stock price. Compute the ***market value to book value ratio*** and ***price/earnings ratio*.** Compare results to the company's peers.

    [Click&type] [Click&type]

18. Analyze the holding company's cash flow.

    - Compare the holding company's parent only cash flow from operating and investing activities to the amount provided by the thrift through dividends.
    - Determine whether financial flexibility exists from nonthrift sources that would enable the holding company to service its short-term obligations.
    - Quantify the amount of cash flow provided to the holding company by the thrift and determine what the company's cash flow position would be without funds from the thrift.
    - Compare the amount of interest expense on the parent only borrowings to the amount of dividends received from the thrift.
    - Compute the ***fixed charge coverage ratio*** to determine whether the holding company can meets its contractual obligations from current earnings.
    - For those companies unable to fully meet cash flow needs from internal resources, identify the cause and level of the deficit and assess the three year trend.
    - In cases of worsening or deficit cash flow positions, obtain or prepare a maturity schedule comparing the levels of resources available to funding requirements over the short term (up to 90 days), intermediate term (91 days to 1 year), and long term (over 1 year).

    [Click&type] [Click&type]

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

INTRODUCTION

OTS conducts routine off-site monitoring of holding companies. The primary purpose of off-site holding company monitoring is the early identification of material concerns or risks that may adversely impact the thrift. The monitoring process will also help you:

- Identify holding companies that need to be examined ahead of schedule.
- Identify specific areas to review at the next examination.
- Assess compliance with supervisory directives to correct problems uncovered in prior examinations.
- Evaluate whether the holding company adheres to conditions of approval and business plans.
- Determine whether it is necessary to modify a holding company's rating or risk classification category.
- Assemble data, information, and analysis to support examinations.

Monitoring provides you an effective means to identify and address potential problems, without being overly intrusive in the day-to-day operations of the holding company. Nevertheless, you are encouraged to communicate with the holding company between examinations.

Ongoing communication enhances our supervisory efforts and keeps us informed of any changes in strategic direction or significant transactions that may adversely impact the thrift. You must not underestimate the need for ongoing dialogue with the management of the holding company. Such communication becomes particularly important when it comes to holding companies involved in industries that are either highly cyclical or rapidly evolving.

Periodic face-to-face meetings are appropriate for holding companies categorized as high risk or complex (Category II). Such meetings enable you to have the benefit of more up-to-date information about major business initiatives.

PRIORITIZING AND SCOPING MONITORING REVIEWS

You have broad discretion in determining the priority and scope of each monitoring review. Regional monitoring reviews should be risk-focused. *Ideally, you should complete holding company monitoring in conjunction with thrift monitoring to ensure a complete understanding of the relationships and interdependence between the parent and its thrift subsidiary.*

Prioritizing Monitoring Reviews

In prioritizing the monitoring of the holding companies in your caseload, you should consider:

- The holding company's relationship with the thrift and any potential burden that it places on the thrift (for example dividends, tax or expense payments).
- Any significant deterioration in the financial condition or performance of the holding company that may adversely impact the thrift.
- The significance of the thrift in the consolidated holding company organization.
- The holding company risk classification category.
- The holding company enterprise's composite rating and CORE component ratings, when available.
- Examination ratings assigned or concerns noted with regard to the subsidiary thrift.
- The asset size of both the holding company and the subsidiary thrift.
- Any significant events such as a proposed merger or acquisition.

For shell holding companies that have no debt, your monitoring activities should focus on the thrift condition/performance and any intercompany transactions or payments. For complex and diversified holding companies and shell holding company with outstanding debt, your review must address any significant deterioration in the financial condition or performance of the holding company that may result in an adverse impact on the thrift. By giving you an indication of the level of diversification and leverage, the following ratios may assist you in prioritizing your monitoring reviews.

Level of Diversification:

$$\frac{\text{Holding Company Assets}}{\text{Thrift Assets}}$$

This ratio will be higher for holding companies that have more holdings in nonthrift operations or investments. A ratio of 100% indicates that the holding company has no other assets besides the thrift (for example, a shell holding company), whereas a ratio of 200% would indicate that the thrift's assets represent one half of the holding company's consolidated assets. Higher ratios indicate a greater diversification from thrift assets and, perhaps, a more complex holding company structure.

$$\frac{\text{Holding Company Net Income}}{\text{Thrift Net Income}}$$

A ratio of 100% indicates that the holding company may have no other source of income besides the thrift. A ratio of greater than 100% indicates that the holding company has income from nonthrift sources (the higher the ratio, the more income from nonthrift sources). Conversely, a ratio of less than 100% indicates that the holding company's nonthrift operations are experiencing net losses (the lower the ratio, the greater the level of nonthrift losses).

Capital Evaluation:

Total Capital Ratio

$$\frac{\text{Holding Company Total Capital}}{\text{Holding Company Total Assets}}$$

This ratio will provide you with an indication of the overall leverage within the consolidated organization. A negative or low total capital ratio would generally indicate that the holding company has limited capital resources. You should consider the composition of total capital when evaluating the adequacy of holding company capital. Holding companies that have significant balances of intangible assets or other volatile assets relative to capital may not have the same capital stability as one with a comparable total capital ratio and little or no intangible assets. Intangible assets can include goodwill, core deposit intangibles, mortgage servicing rights and other intangible assets. You should consider the characteristics of these assets, particularly where the assets generate predicable cash flows that can be relied upon to fund operations.

Tangible Capital Ratio

$$\frac{\text{Holding Company Total Capital} - \text{Holding Company Intangible Assets}}{\text{Holding Company Total Assets} - \text{Holding Company Intangible Assets}}$$

This ratio provides you with another measure of the leverage in the consolidated organization. A low or negative tangible capital ratio may indicate that the holding company has limited capital resources, however, some intangible assets generate cash flows that could support operational funding. For example, GAAP characterizes mortgage-servicing assets as intangible assets, therefore, you should consider the impact of this component in entities with significant mortgage banking operations.

The tangible capital ratio should not be confused with the regulatory capital requirements imposed by the Federal Reserve Board on bank holding companies. OTS evaluates the adequacy of a

holding company's capital on a case-by-case basis, and tangible capital is one consideration (see Section 300).

You should also consider that deferred policy acquisition costs (DPAC) are currently reported on TFR line HC510 with intangible assets. You should closely evaluate the composition of HC510 to understand the strength of the holding company capital structure.

Intangible Assets/DPAC Ratio:

$$\frac{\text{Intangible Assets and DPAC}}{\text{Total Capital}}$$

This ratio will assist you in evaluating the composition of total capital. When the amount of intangible assets or DPAC represent a large percentage of total capital, you should evaluate the attributes of these assets to determine whether the assets provide financial benefits to support operations.

Double Leverage Ratio

$$\frac{\text{Thrift \$ Equity}}{\text{Holding Company \$ Equity}}$$

This ratio can provide you with an indication of double leverage in the consolidated organization, however, the ratio is generally ineffective in identifying double leverage in holding company organizations that have other nonthrift subsidiaries. A higher double leverage ratio could indicate more significant holding company reliance on debt to fund its equity investments in the thrift. Generally, the more double leverage in the consolidated organization, the larger the holding company's cash flow demands will be to service interest payments and debt retirements. In a shell holding company, high double leverage may cause the holding company to seek significant capital distributions or other cash payments from the thrift.

Dividend Payout Ratio

$$\frac{\text{Thrift Cash Dividends to Holding Company}}{\text{Thrift Net Income}}$$

Dividends paid to the holding company may diminish the thrift's ability to augment capital and support the thrift's risk profile. Thrifts that have higher dividend payout ratios may be less capable of supporting their own risk profile from internally generated funds. You should closely evaluate the organization's capital management practices in situations where the thrift distributes a significant share of its net income to the holding company, particularly when the thrift net income represents the major source of the holding company's consolidated net income.

Scope of Monitoring Reviews

The scope of your review should be broad enough to obtain an understanding of the following three broad areas:

- An overview of the holding company, including its organizational structure, primary activities and business plans.
- The holding company's relationship with the thrift, especially its dependence on the thrift or the thrift's dependence on the holding company.
- The holding company's financial condition and performance.

There are a variety of information sources that can help you monitor these three areas. These informational sources include:

- Thrift Financial Report (TFR) Holding Company Schedule (Schedule HC), other TFR schedules, and relevant peer or trend ratios;
- Company or competitor press releases;
- Filings with the Securities and Exchange Commission (SEC);
- Equity and debt market or company analysis;
- Stock price/market data;
- Shareholder reports;
- H (b)–11 Annual/Current Report;

- Annual audit reports;
- Holding company examination reports;
- Subsidiary thrift examination report(s);
- Input from both the thrift and holding company EICs;
- Application approval orders and conditions;
- Pending application materials;
- Consumer complaints;
- Data supplied by other regulators, including examination reports;
- Thrift, holding company and other affiliate websites; and
- Industry websites.

As you conduct your routine monitoring, you should, at a minimum:

- Analyze the quarterly Schedule HC and ratio reports available on OTS national systems.
- Review periodic reports such as the Annual/Current H-(b)11 Reports, annual audit reports, SEC filings, as well as other information provided by a holding company's functional regulator.
- Review industry or publicly available information, including equity and credit analysis.
- Monitor compliance with major application approval conditions.

Analyzing Schedule HC and Internally Generated Reports. Schedule HC is filed quarterly by the subsidiary thrift. For most holding company enterprises, there is one holding company designated to provide this financial information. In some cases, where more than one distinct ownership path exists, there may be more than one designated filer. As you analyze this information, you should test the accuracy of the financial data reported. In addition, you must realize that even though the information is provided on a consolidated basis for the designated filer, there may be upper tier holding companies that are not reflected in the data. Therefore, you may want to coordinate your review of Schedule HC with your review of the holding company's comprehensive audited financial statements. These statements are usually filed as an attachment to the Annual/Current H-(b)11 Report.

The collection of the limited data on Schedule HC can provide an indication of the holding company's financial condition and useful trend information. As noted above, the holding company data and ratios generated from Schedule HC are most effective for holding companies with limited activities beyond the thrift investment. The ratios produced from Schedule HC for more diversified holding company structures are often less effective at providing clear indications of risk. For more diversified holding companies, your monitoring efforts should focus on analyzing SEC filings or other comprehensive financials provided in the H-(b)11 filing, and other publicly available financial information or analysis.

As you analyze Schedule HC, you should review the Evaluating Capital on a Case-By-Case Basis discussion in Section 300, Capital and the Ratio Analysis discussion in Section 600, Earnings. In these discussions, we describe ratios that can be used to analyze and spot trends regarding the holding company or consolidated group's capital adequacy, leveraging, earnings, liquidity, cash flow and reliance on subsidiary dividends. They can also be used to evaluate various financial aspects of the holding company enterprise's relationship with the thrift.

Please note, however, the ratios outlined in Sections 300 and 600 are only indicators that closer scrutiny is warranted; they should not automatically be assumed as indicative of a problem.

Periodic Reports. Holding companies must file periodic reports as defined by OTS. Current OTS requirements for periodic reports are outlined in the instructions to form H-(b)11 Annual/Current Report. This report must be filed by holding companies within 90 days of their fiscal year end. In addition, quarterly updates must be filed within 45 days of the end of each quarter during which

there has been a material change in any of the information reported. If no changes have occurred, the holding company must file a statement certifying such.

The H-(b)11 provides important data on:

- The corporate structure
- The relationship with the thrift
- Dividends from the thrift
- Intercompany tax sharing
- Debt/securities

The holding company also files audited financial statements and copies of its SEC filings under cover of the H-(b)11.

Industry/Publicly-Available Information. As companies get larger and more complex, we cannot rely exclusively upon our own systems. Therefore, your offsite monitoring must also make effective use of market information, including analyst and rating agency reports, press reports and stock price and volume movements. These types of public information will help you identify issues to discuss with management. For holding companies with:

- Banking as their primary business, see www.fitchratings.com (FITCH IBCA, DUFF & PHELPS).
- Insurance as their primary business, see www.ambest.com (AM BEST).
- Diversified activities, see www.standardpoor.com (STANDARD & POORS). The Forum section includes "Ratings Commentary" on industries including Financial Institutions and Insurance. In addition, the "Ratings Actions" section includes ratings news.

In enterprises that have another primary regulator, you should leverage off of the other regulator's information and resources. In particular, you should review any examination reports, and any financial reports that the enterprise submitted. For further information on reviewing enterprises with functionally regulated entities, see the functional regulation discussion in Section 200, Administration.

Monitoring of Major Application Approval Conditions. OTS approves applications subject to the applicant thrifts and/or holding companies agreeing to maintain compliance with application approval conditions. Major applications will generally include those applications that are likely to substantially increase the risk profile of the thrift or holding company; involve novel or complex transactions; or that propose a significant shift in business strategy. All complex holding company and de novo applications are considered major applications.

Each OTS Region is responsible for monitoring and documenting a thrift or holding company's compliance with:

- All written application approval conditions.
- Any other written representations made to OTS either in the application or during the application process which were important considerations in the approval of the application, but which were not memorialized in a condition. These include issues requiring follow-up that may be found in departmental clearance memos or the supervision digest.
- Business plan projections. This includes performing a quarterly review of the thrift or holding company's adherence to the financial projections furnished by the applicant and accepted by the region. This review should assess both the volume and type of business activities in order to evaluate the riskiness of actual versus proposed operations.

If the thrift or holding company is not in material compliance with a significant approval condition or application issue, or if there are material variances from its business plan projections, areas of noncompliance must be identified and routed through the supervisory chain to the attention of the Regional Director. Supervisory corrective ac-

tion will be implemented based upon regional evaluation of the severity of the noncompliance.

The monitoring requirements for major applications sunsets three years from the later of: (i) the date of approval of the application; (ii) the date of commencement of operations for de novos; or, (iii) the date of the Regional Director's approval of any major revision of the business plan.

MONITORING DOCUMENTATION

You should document your quarterly HC monitoring findings for any areas where you identify significant financial deterioration or supervisory concerns. Your review comments should be presented in a simple bullet point, exception-based, format. For each area of significant deterioration or concern, you should:

- Explain the cause and impact of the deterioration or concern; and
- Detail any planned corrective actions or necessary supervisory follow-up.

If your analysis does not reveal any significant deterioration in the financial condition or performance of the holding company, and does not reveal any new information that would be a cause for supervisory concern or supervisory action, a single sentence indicating such findings will suffice.

INTRODUCTION

Section 10(l) of the Home Owners' Loan Act (HOLA), permits a state savings bank (or a cooperative bank) to elect to be treated as a savings association for purposes of regulating its holding company. The only requirement that a state savings bank or cooperative bank must satisfy in order to make this election is that it must be a qualified thrift lender.[1] By making such an election, the holding company is regulated by OTS as a savings and loan holding company for purposes of Section 10 of HOLA, rather than as a bank holding company.

Insured subsidiary state savings banks are primarily regulated by the FDIC and the state. However, being deemed a "savings association" for purposes of Section 10 of HOLA results in not only OTS regulation of the holding company, but also OTS regulation of certain requirements that apply directly to the insured subsidiary institution. For example, Section 10(d) subjects the insured subsidiary institution to transactions with affiliate restrictions (as implemented by OTS at 12 CFR Sections 563.41 and 563.42). In addition, Section 10(f) (as implemented by 12 CFR 563.140, Subpart E) requires the subsidiary insured institution to file advance notices of dividend declarations with the OTS.

OTS will need to coordinate with both the chartering authority(state) and insurer(FDIC).

OTS PHILOSPHY IN REGULATING 10(L) HOLDING COMPANIES

Although it is clear that OTS has the authority to examine 10(I) holding companies, this can present a challenge because OTS does not directly supervise the insured subsidiary institution. Our holding company examination approach is designed to assess the holding company enterprise's effect on the insured institution. This examination process may initially seem awkward, but has proven effective when closely coordinated with the FDIC and State examination of the subsidiary savings bank. By comparison, the Federal Reserve Banks also examine bank holding companies that own national banks, state nonmember banks, or savings associations that they do not regulate directly.

In order to accomplish the examination objectives, you will have to work closely with the depository institution regulators to assess the effect of the holding company's operations on the insured subsidiary institution. It is generally best to conduct the holding company examination in conjunction with the examination of the insured subsidiary institution. Whether you conduct the examination concurrently or not, you must establish and maintain open communication channels with the other regulators. The importance of such communication, from scheduling to examination findings, will be made clear in this Section.

SCHEDULING AND SCOPING THE 10(L) EXAMINATION

Because our databases do not contain information on the insured subsidiary institution, the default holding company examination due date is based on an annual cycle. This due date should serve as only a general guide and reminder to coordinate the scheduling and scope of the holding company examination with the examination of the insured subsidiary institution.

In setting the scope, you should contact the insured subsidiary institution's regulators and inquire whether they have any special concerns with the holding company relationship. You should address any such concerns in the course of your examination of the holding company. As a means to familiarize yourself with the subsidiary insured institution, you should also:

[1] A company that controls a state savings bank or cooperative bank seeking to take the 10(I) election that is not already a registered savings and loan holding company must also file an H-(e) Acquisition Application and receive OTS approval to become a savings and loan holding company. As part of that application process, the OTS reviews the financial and managerial resources, as well as the future prospects, of the proposed holding company and the insured subsidiary institution.

- Obtain and review the latest examination reports of the subsidiary.
- Review financial information available on the FDIC website.
- Obtain financial statements and monitoring reports used by holding company management to oversee their investment in the insured subsidiary institution.

As you review the books and records of the holding company, you should not only review the areas of concern specifically noted by the regulators, but also watch for red flags that would raise concerns if the subsidiary were directly regulated by OTS. This includes high risk activities engaged in by the holding company or other affiliates that could adversely affect the insured institution. You should bring all concerns that may affect the insured subsidiary institution to the attention of the state and federal regulators.

As with any other holding company examination, you should start with the Administrative Program Section 710 to identify the holding company's risk classification. You then use the Abbreviated Holding Company Examination Program Section 720 for low risk holding company enterprises (Category I), recognizing that you may need to consult the CORE Holding Company Examination Program Section 730 to address specific areas of risk. You should use the CORE Holding Company Examination Program Section 730 for all higher risk or complex holding companies (Category II).

You should review all four of the CORE technical areas of a holding company examination: Capital, Organizational Structure, Relationship and Earnings.

Capital

As discussed in Section 300, OTS does not uniformly impose either consolidated or unconsolidated numerical regulatory capital requirements on holding companies. An institution may view this as a benefit of OTS regulation, and, therefore, may elect 10(l) status to avoid standardized application of a numerical capital requirement on its holding company.

OTS expects all thrift holding companies to have a prudent level of capital based on their risk profile. This holds true for 10(l) holding companies. You should evaluate the 10(l) holding company's capital position to determine its effect on the insured subsidiary institution. As part of that analysis, you should determine whether or not the 10(l) holding company's capital position has deteriorated since the last examination, and whether or not significant asset/liability restructuring, acquisitions, or divestitures have occurred that may negatively affect the financial or managerial relationship between the institution and the holding company.

As also noted in Section 300, capital provides a secondary source of financial protection for the holding company if earnings and cash flow prove insufficient. During the examination, you should fully evaluate the capital of the holding company; especially for companies that are experiencing cash flow problems, or weak earnings capacity, or rely on the institution for working capital since this may result in the institution being pressured to upstream funds. A 10(l) holding company that has capital does not necessarily have sufficient cash flow to meet contractual obligations when they are due.

In the report of examination, you should discuss dividends and stock repurchases that occurred during the review period, as well as those that are planned. Further, you need to state to what extent, if at all, the holding company is reliant on insured institution funds to support the parent's dividend payments or stock repurchases.

You also need to closely analyze the level of debt at the holding company. You should investigate how the holding company has historically serviced its debt, and what factors caused the holding company to increase its debt level. Does it assume additional debt to provide for the payment of dividends? Does it rely on the insured subsidiary institution to upstream funds? You should contact the depository institution's regulators concerning significant levels or increases in

debt at the holding company level that may negatively affect the insured subsidiary institution.

You must also evaluate whether double leveraging is occurring and what risks it may pose. Double leverage exists when funds obtained by the holding company from debt proceeds are invested into the institution subsidiary as equity. Increasing the capital base of the institution allows it to increase its borrowings/leverage as well, thereby compounding the original holding company debt and resulting in higher consolidated debt/ leverage. In this situation, the institution's earnings must be sufficient to service both levels of debt and typically the parent will rely upon dividends from the insured subsidiary institution to provide the funding for its debt service requirements. If the institution is unable to maintain earnings to support future dividend payments, the holding company will be unable to pay its debt obligations as well. In this regard, it is important to assess the financial strength of the insured subsidiary institution, as well as the holding company, to ensure that debt requirements can be met.

Organizational Structure

In this Section, you will focus on the structure and activities of the holding company. You will also look at the issue of control of the holding company in order to determine if there have been changes in the ownership structure and what regulatory processes apply. Then you need to analyze the various activities in which a holding company may be involved. As discussed thoroughly in Section 400, there is a correlation between how a holding company is structured and the kind of activities in which it may engage.

Many of the 10(l) holding companies that we regulate are holding companies of federal savings associations that converted to state savings banks. These entities were familiar with OTS holding company regulation, or otherwise perceive advantages to being treated as a savings and loan holding company, and, thus, elected 10(l) status.

Some holding companies may elect 10(l) status after such a conversion as a means to be able to engage in broader activities. Such holding companies may qualify as exempt if they continue to control a savings association that they controlled on May 4, 1999, and that institution is a qualified thrift lender (QTL). Further, an insured institution must be a qualified thrift lender to elect and maintain 10(l) status. Accordingly, you must verify the institution's QTL status at each examination.

Once the holding company structure and activities are determined, the review will then focus on what risks, if any, exist that may affect the insured subsidiary institution. However, consistent with the current regulatory approach, this assessment should not be limited to current risks that may be evident, but also to prospective risks. You need to determine whether there are elements regarding the structure or business interests that hold potential risks for the institution.

Relationship

This Section addresses the effectiveness of the holding company's board and executive management, as well as issues associated with the interdependence of the insured subsidiary institution. You should analyze the degree of influence the holding company has over the institution and how this influence affects the institution's operations.

Specifically, identify the principal decision makers of the holding company. Are these individuals also directly involved in managing the affairs of the insured institution? Does the holding company have policies and procedures in place to ensure that the insured institution has a separate corporate identity, and conflicts of interest are avoided? Does the board of directors provide adequate oversight of the affairs of the holding company and its subsidiaries? How actively involved is the holding company in the management of the institution? Does the organizational structure of the holding company foster interdependency risk that could hurt the institution if the holding company becomes financially distressed? You should communicate any significant concerns about the management of the

holding company, especially potential conflicts of interest, to the insured subsidiary's regulators.

Assess the risks posed by integrated systems, common risk management practices, central decision making, joint marketing and delivery systems, linked market reputation, size of the institution in relation to the holding company, and common controls.

Moreover, it is important that the principles of an arm's length transaction be applied to all transactions between the insured institution and its affiliates. This approach provides protection for all the interests involved. In addition, payments should be made within a reasonable time of the rendering of the services. During the examination, you must determine that present practices are consistent with internal policy. Once you establish that the fee structure is reasonable and consistently followed, then determine if the insured subsidiary institution is actually receiving the services for which it is charged. This can usually be ascertained by discussing the services with the EIC of the insured subsidiary institution.

The affiliate transaction regulations apply to the insured subsidiary institution. Therefore, the insured subsidiary's regulators will in all likelihood review this area.[2] Nevertheless, while you are conducting your examination of the holding company, possible transaction with affiliate issues may arise. Keep in mind that all covered transactions of the insured subsidiary institution must comply with the affiliate regulations contained in Federal Reserve Act Sections 23A and 23B and the additional prohibitions contained in section 11(a)(1) of the HOLA.[3]

Covered transactions with a single affiliate, may not exceed 10 percent of a bank's capital and surplus, and transactions with all affiliates may not exceed 20 percent of the bank's capital and surplus. In addition, all transactions must be conducted on market terms. To ensure that the insured institution appropriately reports all transactions, you should advise the other regulators of any transactions that you identify in your review of the books and records of the holding company and other affiliates. This would also include loans or other extensions of credit to insiders of the holding company subject to Regulation O.

In general, you should help facilitate the other regulators' review of this area and verify aspects of affiliate transaction as they are recorded on the holding company's books and records. Furthermore, you should review transactions between affiliates that are outside the scope of the affiliate regulations but, nonetheless, may indirectly impact the subsidiary institution. For example, an unsecured loan made by the holding company to another affiliate or insider. While these transactions are not covered by the affiliate regulations, they do have the potential to deplete the holding company's financial resources and indirectly affect the subsidiary institution.

As you review the relationship of a 10(l) holding company with its insured subsidiary institution, you must remind yourself that although OTS is only the primary regulator for the holding company, you cannot ignore the insured subsidiary institution. As reiterated throughout this Handbook, the OTS approach to regulating holding companies considers both the financial condition and operations of the holding company and the impact of the holding company on the insured institution.

You may encounter transactions or restructurings within the enterprise that do not appear, independently, to be in the best interest of the holding company. Keep in mind that situations do occur where it is appropriate for risky assets or risky lines of business to be transferred from the insured institution or a subsidiary of the insured institution to the holding company. While ultimately we may prefer, from a supervisory perspective, that the assets be sold to a third party or the risky activity discontinued altogether,

[2] In addition, OTS may also review these transactions under statutory authority set forth at Section 10(d) of HOLA (as implemented by 12 CFR 563.41 and 563.42).

[3] Section 11(a)(1) of the HOLA prohibits loans to affiliates engaged in nonbank holding company activities. It also prohibits purchases and investments in securities issued by affiliates.

sometimes there may be sound business reasons for these transactions.

Therefore, just because a transaction is not in the best interests of the holding company, or does not improve its consolidated financial condition, does not automatically mean you should criticize it. Some transactions may, in fact, be structured to safeguard the insured institution. Just because OTS is not the primary regulator for the insured institution does not mean that we do not consider its best interests as we would if OTS regulated all entities within the structure.

Earnings

The key areas to review in the Earnings component of the examination are the holding company's cash flow, profitability, and exposure to highly leveraged investments such as futures contracts. Once again, you should advise the insured subsidiary's regulators of any excessive debt or liquidity concerns that may affect the insured subsidiary institution.

Additionally you should review the funds the holding company receives from the institution. This includes dividend payments, fees for services rendered, and payments made under tax sharing arrangements. You should advise the EICs of the other regulators of the funds that the holding company reports that it receives from the insured subsidiary institution. In addition, you should ensure that the insured institution filed the appropriate dividend notifications with the OTS.[4]

COMMUNICATING WITH THE PRIMARY REGULATOR OF THE INSTITUTION

As reiterated throughout this Section, it is important that you coordinate examinations and communicate with the other regulators of the 10(l)'s insured subsidiary institution. Open communication sets the stage for information exchange and serves two vital purposes:

1) It ensures that we have the opportunity to obtain the primary regulator's perspective and supervisory concerns with respect to the insured institution or its relationship with the holding company.

2) It promotes sharing of our supervisory concerns and examination findings and conclusions.

While the examination report is the appropriate vehicle to communicate conclusions to the holding company, it may not necessarily cover everything that you should communicate with the other regulators. Your communication with the insured subsidiary's regulators will usually be done during concurrent holding company and insured subsidiary institution examinations. Communication efforts should begin, however, with the scheduling of the examinations and continue through finalizing your conclusions with regard to the 10(l)'s impact on the insured subsidiary institution.

For ease of reference, the following list summarizes some of the key points you should communicate:

- The timing, scheduling and preliminary scope of the holding company examination. The examination should be scheduled, to the extent possible, concurrently with the examinations of the lead subsidiary institution by the other regulators.
- The adequacy of the holding company's consolidated capital, and any trends or deterioration since the last examination.
- Significant cash flow or liquidity concerns.
- Any significant restructurings, acquisitions, or divestitures that may affect the institution.
- Any dividends or stock repurchases that the holding company depends on institution funds to support or are otherwise significant.
- Significant levels or increases in consolidated debt or double leverage, considering how re-

[4] As a "savings association" controlled by a "savings and loan holding company," the insured institution is subject to Section 10(f) of HOLA (as implemented by 12 CFR 563.140).

liant the holding company is on the insured subsidiary institution to service such debt.

- How the insured subsidiary institution fits within the corporate structure, and how the holding company's goals and objectives or strategic plans may affect the insured subsidiary institution.
- Any activities conducted within the holding company structure that are high risk or could otherwise adversely affect the insured subsidiary institution.
- Any concerns about the management of the holding company, especially potential conflicts of interest.
- Transactions between the holding company or other affiliates and the insured subsidiary institution, as well as transactions between affiliates that may indirectly impact the subsidiary institution. Include funds the holding company receives from the institution (for example, dividends, fees for services rendered, or payments made under tax sharing arrangements).

Upon completion of your review, you will need to consult with the other regulators to enable you to rate the holding company based on its effect on the insured subsidiary institution. You should complete the holding company examination report and outline any areas of concern that you and the other regulators conclude are significant. If corrective action is necessary, you should work closely with the other regulators to formulate a joint strategy. It may be appropriate to address concerns at either the insured subsidiary institution or the holding company, or both simultaneously. Coordinated enforcement actions generally ensure that the full attention of both the holding company and the insured subsidiary institution are devoted to taking the necessary corrective action.

You need to be aware that while OTS examination authority is clear, our ability to conduct formal investigations is limited to violations of Section 10 of HOLA. The other regulators of the insured subsidiary institution should take the lead on enforcement or other corrective action required of the insured subsidiary institution itself or with regard to its relationship with the holding company. OTS should take the lead on enforcement or corrective actions relating to violations of Section 10 of HOLA and concerns at the holding company.

INTRODUCTION

This Section will help you recognize the unique issues presented by a mutual holding company (MHC) structure. An MHC structure is fundamentally different from a traditional savings and loan holding company structure. An MHC structure combines the elements of a mutual thrift, which is owned and controlled by its depositors and, in some cases by its borrowers, with elements of a stock thrift and holding company.

An MHC is the result of a conversion of a mutual institution to become a stock institution. The MHC becomes the corporate repository of the mutual members' economic and legal interests. It must own a controlling interest in the newly created stock institution, but it may sell up to 49.9% of the institution's voting stock, as well as any nonvoting stock, as a means to raise capital. Even when there is no issuance of stock to the public, there is still stock that has been issued to form the structure.

Not all MHC structures will look the same. In all cases, the thrift becomes a stock institution. Some structures will include a mid-tier stock holding company between the stock thrift and the MHC.[1] Other structures will include only the stock thrift that is directly owned by the MHC.

By creating the MHC structure in 1987, Congress provided an alternative to a full conversion from a mutual to stock form.[2] It provides a means for the members to continue to influence and control the operations of the institution, while also providing a means to raise capital. Mutual institutions that traditionally had little choice but to accumulate capital through retained earnings can use the MHC structure to sell minority stock interests.[3] The MHC structure can also be used as a vehicle to engage in activities under the holding company umbrella.

The guidance in this Section will help you assess the risks that the MHC structure poses. You must consider the combined risk profile, financial health and stability of the consolidated enterprise, the influence of minority shareholders and the degree of interdependence between the thrift, a mid-tier stock holding company (if one exists), and the MHC. You should base your examination conclusions on the current and prospective effect the structure has on the subsidiary thrift.

EXAMINATION COMPONENTS

The MHC form of organization may affect your examination steps. In addition to the standard examination procedures used for a stock holding company, you should evaluate the following unique areas of concern presented by an MHC.

Capital

As noted in Section 300, OTS does not have a standardized capital requirement that applies to all holding companies. Instead, capital is evaluated on a case-by-case basis determining the amount of capital necessary to support the risks within the structure.

Dividend Waivers

To allow more capital to remain at the thrift, thereby increasing the capital position of the thrift, an MHC may waive its right to receive a dividend. Needless to say, this has an impact not only on the thrift, but also on the level of capital at the MHC available to support its other activities. Prior notice must be provided to OTS.

[1] A mid-tier stock holding company exists between the parent MHC and the thrift. The majority of shares in the mid-tier stock holding company must be issued to the MHC, and the mid-tier stock holding company must own 100 percent of the shares of the subsidiary thrift.

[2] An MHC may subsequently decide it wants to pursue a full conversion. This later action also requires OTS approval, and is referred to as a second step conversion.

[3] While mutual institutions may receive pledged deposits and issue mutual capital certificates and subordinated debentures, they rarely use these options.

Dividend waivers must not be detrimental to the safety and soundness of the subsidiary thrift. Dividend waivers also require a board resolution that the waiver by the MHC is consistent with the directors' fiduciary duty to the mutual members.

The waiver of dividends by the MHC allows for any dividend declared by the thrift to be distributed only to the minority shareholders. The potential for a conflict of interest exists when directors and officers are deciding whether or not to waive dividends. If the directors and officers also hold stock, the financial decisions they make may personally benefit them. You should determine if the waiver has unduly enriched the minority shareholders at the expense of the MHC members.

The waiver of dividends may also result in atypical per share results. Earnings per share calculations are made using all outstanding shares, both those held by the MHC and the minority shareholders. On the other hand, dividends per share calculations are typically made using only the number of shares that will receive dividend payments. If the MHC waives its right to a dividend, this will result in a calculation using only the number of outstanding minority shares. For example, assume net income of $20 million, dividends of $9 million on the 4 million shares owned by the minority shareholders, and dividends waived on the 6 million shares owned by the MHC. Earnings per share are $2.00 ($20 million /10 million shares). Dividends per share are $2.25 ($9 million /4 million shares). From these ratios, it might appear that dividends exceeded net income ($2.25 per share vs. $2.00 per share), when in fact dividends were only 45% of net income ($9 million/$20 million).

Organizational Structure

As discussed in Section 400, many thrift holding companies operate without activity restrictions. However, ***all MHCs and their subsidiaries are subject to activity restrictions***.[4] An MHC may engage in the same activities as a stock holding company subject to activity restrictions[5]. The permissible activities for holding companies subject to activity restrictions are outlined in Section 400.

Relationship

A unique aspect of the MHC structure is the ownership of the MHC by the members. This group may exhibit little interest in the activities that occur and may not realize their potential for involvement in the organization. The structure may operate with a small group of individuals exercising exclusive control over the entities within the structure.

Board Responsibilities

The existence of an MHC, and possibly a mid-tier stock holding company, adds complexity to the structure.

The boards of directors of the thrift, mid-tier holding company (if one exists) and MHC may be comprised of the same, or mostly the same members. However, you should ensure that the boards of directors of each entity in the structure operate independently. The boards of each organization have distinct responsibilities. Each entity must maintain a separate corporate identity and interrelationships among the companies should not be detrimental to the institution. MHCs and mid-tier boards may meet less frequently than thrift boards because they are typically shell entities. You should evaluate how effectively each Board operates in executing its duties and responsibilities. The interests of one entity in the structure should not be sacrificed for the benefit of another entity in the structure.

You should review board minutes to determine if adequate discussion and analysis of issues occurs at each level in the structure.

[4] 12 CFR § 1467a(o)(5).

[5] 12 CFR § 575.11.

Minority Shareholders

The addition of minority shareholders into a traditional mutual environment may result in change for the thrift. Minority shareholders, particularly those elected to the board of directors, may bring a fresh perspective from experiences in other organizations or industries. This additional perspective may help the organization to identify new ideas and enhance the thrift's potential for long-term growth. Minority shareholders may also create friction within the organization. A focus on dividends may result in unreasonable demands for increased earnings or dividends that may weaken the capital position of the subsidiary thrift.

Minority shareholders may call for activities that increase shareholder value through the sale or merger of the thrift with another institution. This may result in the board and management focusing on trying to appease shareholders rather than focusing on activities in the long-term best interest of the structure.

An option available to MHC's is a second step conversion. This enables the entity to convert to a stock structure. OTS requires a majority vote of minority shareholders to approve any second step conversion.

Earnings

The Earnings section of this handbook provides a number of useful ratios for analyzing the financial statements of each entity in the MHC structure.

Pure mutual organizations may have the goals of customer service as a priority over profit maximization. The shift to an MHC structure, with the resulting influence of shareholders, may create pressure for increased earnings.

Financial Statement Analysis

Financial statement analysis in an MHC structure will include evaluations of statements of each entity in the structure. Intercompany transactions should be evaluated closely. Your examination should determine that transactions that occur are properly authorized, recorded and reported, and assess the direct or indirect impact on the thrift. Transactions that may appear appropriate when only one entity is reviewed, may appear questionable when both sides of the transaction are reviewed together.

There should be a tax allocation agreement between the MHC, mid-tier and thrift. The allocation should ensure that the thrift does not assume a larger tax burden than it would if it filed independently.

The allocation of revenues and expenses between the savings association, affiliates, and holding companies should be based on a documented method that is systematic, rational, and consistent with sound principles of corporate governance. In the absence of an appropriate allocation, reported earnings could be significantly different from that which would have been the case had there not been the intercompany relationships. You should question the allocation if it does not track with the earnings activities of, or the economic benefits derived by, the separate entities. For example, the allocation of all legal costs incurred by, and for the benefit of, the savings association to an MHC, which has no significant operations of its own, is generally not appropriate. As a result, earnings of the MHC would be understated, while earnings of the savings association would be overstated. Where minority shareholders are present in the structure, they would benefit, to the detriment of the MHC. This is because the MHC would effectively bear more than its pro rata share (based on ownership) of the savings association's legal costs.

SUMMARY

The MHC structure expands the options available to mutual savings associations. The structure allows the organization to maintain many of the features of a mutual while providing access to capital markets.

Consistent with the general holding company philosophy and supervisory approach, the examination of an MHC structure should consider the direct and indirect impact on the thrift institu-

tion. Furthermore, since the MHC is the repository of the mutual members' economic and legal interests, you should insure that the directors and officers of the MHC are properly fulfilling their fiduciary responsibilities.

REFERENCES

United States Code (12 USC)

§1467a(o) Mutual Holding Companies

Code of Federal Regulations (12 CFR)

Part 575 Mutual Holding Companies

INTRODUCTION

Although commonly thought of as one industry, the insurance industry actually consists of several distinct industries. Each distinct industry is based on the type of insurance written, for example, property/casualty, life/health, health maintenance organizations, title, and disability[1]. Each functions in its own way, has distinct financial attributes and operates differently. OTS-chartered thrifts are owned by a variety of these different types of insurance entities.

The insurance industry is comprised of several different types of businesses:

- Insurance companies, also called insurance underwriters – those that take on insurance risk by underwriting and issuing policies to customers.
- Reinsurers – insurance companies that insure portions of the business underwritten by other insurance companies.
- Agents – sales staff, either employees or independent contractors that sell on behalf of the companies they represent.
- Brokers – sales staff that is independent of insurance companies, they bring together insurance buyers and sellers. They work on behalf of the buyer.

State insurance departments regulate each type of insurance business listed above in a different way and to a different extent[2].

As with any holding company, you need to start with the administrative program and then move onto the CORE program (or abbreviated program if applicable).

[1] Information about insurance industries is presented in Appendix A.

[2] Regulation by state insurance departments is discussed in Appendix B.

PROGRAM GUIDANCE

Capital

Information presented in Capital Section 300 is just as relevant to insurance entities as to other types of organizations. However, you should consider the information presented below before drawing firm conclusions about a holding company enterprise that is engaged in insurance activities within the structure.

Capital Sufficiency

Capital levels for insurance companies are typically relatively high. This is due to strong investment performance during the 1990's and significant investment regulation[3]. In addition, due to the risk of catastrophes and the long-term nature of life insurance policies, higher capital levels are typically held. Recent events may result in a reduction of capital for certain companies. However, the industry overall is expected to remain strong.

Risk-based capital (RBC) is the major tool used by insurance regulators to evaluate the adequacy of an insurance company's capital level on a statutory accounting basis.

Insurance companies are part of a highly regulated industry. This level of regulation may result in restrictions against providing capital to the thrift. Evaluate the existence and/or adequacy of holding company capital in support of the thrift. This evaluation of consolidated capital should exclude the capital related to regulated insurance companies and any other regulated entities such as state banks. The remaining amount of capital should then be evaluated for its adequacy in support of the subsidiary thrift.

An evaluation of capital would also include a determination of any existing capital restrictions by

[3] Capital regulation of the insurance industry is discussed further in Appendix A.

another regulator. For affiliates that are regulated by another state or federal agency, determine if there are any agreements or conditions imposed that would require the holding company to devote financial resources (including capital contributions) to that entity. If such agreements or conditions exist, determine the extent to which they could ultimately have an adverse effect on the subsidiary thrift.

RBC is calculated at the individual insurance company, rather than enterprise level. Distinct RBC formulas are available for property/casualty, life and health maintenance organization companies.

The calculation involves applying risk factors to various asset, premium and reserve items. The factors are higher for items with greater underlying risk and lower for items with lower underlying risk.

As noted above, state insurance regulators measure an insurance company's capital by its risk-based capital ratio. The ratio is total adjusted capital divided by authorized control level risk-based capital. Results of 200 percent or above typically indicate little concern. Results below 200 percent may result in insurance department actions.

OTS' approach to holding company supervision provides for the evaluation of capital on a case-by-case basis. Holding companies that underwrite insurance will prepare Statutory Accounting Statements either in addition to, or instead of GAAP statements. In those instances, SAP capital can be used as a measure of capital similar to tangible capital.

Risks

Capital Section 300 of the Handbook discusses various types of risk that organizations must address. The insurance industry also must deal with Underwriting Risk.

Insurance is a unique product in that the ultimate cost is sometimes not known until long after the product is sold. Underwriting risk is the risk that premiums will be inadequate to cover the cost of claims that occur during the policy periods. Insurance prices are established based on estimates of expected claim costs as well as estimates of the costs to issue and administer the policy. The estimates and assumptions used to develop policy pricing may prove to ultimately be inaccurate. This inaccuracy may result from poor assumptions, changing legal environments, increased longevity, higher than expected weather catastrophes and research breakthroughs as to the causes of disease[4]. The total cost of the policy may not be known until many years after the coverage has been provided. Factors that were unknown at the time the policy was issued may result in increased claims and claims costs.

Liquidity risk is typically less likely to be of concern in an insurance organization due to the extensive structure of investment regulation. Often 75 percent or more of an insurance company's assets are concentrated in the investment portfolio. Insurance investments are heavily weighted in bonds rather than stock.

Insurance company investments are typically structured to focus on providing for adequate diversification, liquidity and quality. The primary objective of an insurer's investment strategy is to preserve capital. Insurers invest largely in long-term bonds with fixed interest rates and predictable cash flows.

Life insurance companies present a unique aspect in evaluating capital. Variable life insurance and variable annuities are accounted for through the use of separate accounts. Policies accounted for in this way require no supporting capital. Capital calculations for companies with separate accounts

[4] Medical research may find the cause of a disease relates to a product thereby creating insurance claims outside of health insurance. For instance, several serious lung conditions have been traced to asbestos exposure resulting in large volumes of claims to manufacturers of asbestos. Lead paint has been linked to mental and physical impairment in children resulting in claims against paint manufacturers and landlords.

should be made excluding the amount recorded in that category[5].

Debt

Due to the strong capital levels and large investment portfolios most insurance organizations carry little debt. Procedures presented in Capital Section 300 related to debt may not be needed when evaluating many insurance holding companies.

Most insurance companies have negotiated terms for substantial letters of credit. These agreements are in place, available to activate in the event of a catastrophe. This type of agreement is not drawn on for operating funds or to finance growth, rather only for those infrequent, major events that require large amounts of immediate cash. The existence of these prenegotiated agreements provides the company the ability to obtain cash quickly without liquidating portions of the investment portfolio. The agreements help to minimize the impact that the sale of investments in a poor investment market would have on a company's operating results.

Dividend Policies

State insurance regulation typically includes restrictions on dividends from the underwriting company to the parent holding company. Dividends that do not require prior insurance department approval are limited to the current years earnings and ten percent of surplus as of the beginning of the year. Dividends in excess of that must receive prior insurance department approval.

As part of evaluating the financial condition of the holding company, the examiner should determine the impact reduced earnings (limiting dividends) would have on the cash flow needs of the holding company.

[5] Information about Separate Accounts is included in Appendix A.

Accounting Methods

You may find that companies that underwrite insurance may not have their financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP). Instead, companies that underwrite insurance must file their financial statements with state insurance departments using what is referred to as statutory accounting principles (SAP). Publicly traded insurance underwriting companies must file GAAP statements with the Securities and Exchange Commission in addition to the SAP statements filed with the state insurance departments. Mutual or closely held companies typically only prepare SAP statements.

When reviewing financial statements, you should determine if the company prepares both SAP and GAAP statements or if only SAP statements are prepared.

If the holding company itself is not engaged in insurance underwriting activities and only controls or has investments in insurance companies, financial statements would be prepared using GAAP, SAP would not be used.

Ratio results calculated using SAP numbers would appear less favorable than those prepared using GAAP numbers. You should not automatically evaluate this more conservative result harsher than a GAAP result.

Companies that underwrite insurance often have diverse affiliates and subsidiaries within the structure; therefore, the statements at the ultimate parent may be complex. Because of this complexity it is not practical to simply benchmark results. Rather, a thorough understanding of the company and its various components will provide a comfort level that examination procedures are adequate.

Organizational Structure and Relationship

As noted above, OTS has approved applications for thrift charters for several different types of insurance companies. The thrift has been used by these organizations as a means to fill product line gaps and cross sell related products to existing in-

surance clients. The types of products and services they offer reflect the overall organizations broader marketing strategy.

Several life insurance companies were granted thrift charters to provide trust services to consumers. The companies, whose insurance operations focus on life insurance and retirement and estate planning, use the thrift to provide trust services that complement these activities. Life insurance policies can be used to fund trusts. Retirement funds may be direct deposited into checking accounts. Certificates of deposit may be incorporated into asset diversification plans for retirement or estate planning purposes.

Several property/casualty insurance companies have applied for, and received full service retail charters. The products they offer, including home mortgages and auto loans, complement the auto and homeowners lines of insurance offered.

As the companies gain experience with the thrift and gain proficiency with the ability to cross sell thrift services to existing insurance clients, some have requested expanded authority. Several have acquired other thrifts or received approval to expand their authority to full service from trust only.

Approval of business plans for insurance industry thrifts often include restrictions or requirements. In many instances the insurance company plans for insurance agents to market thrift products. Agents' roles are largely marketing and information only; they are restricted from accepting deposits. In order to assure that this message is communicated effectively, agent training materials often require prior review by OTS before release.

Opportunities arise to cross sell thrift products to insurance clients. Likewise, opportunities exist to cross sell insurance products to thrift customers. Several existing thrifts have chosen to enter the insurance arena either through the creation or purchase of insurance agencies, marketing agreements with agents, or the creation of reinsurance companies.

Gramm-Leach-Bliley addressed concerns related to the sales of insurance products in a banking environment. The requirements of this law have been incorporated into OTS regulation through 12 CFR Chapter V Part 536 – Consumer Protection in Sales of Insurance.

The rule addresses anti-tying and disclosures to reduce customer confusion. A main focus of the rule is to make clear that the Federal Deposit Insurance Corporation does not insure insurance products sold on behalf of a bank or thrift. Compliance examiners review thrift activities for adherence to the rule.

Earnings

As recommended in the Earnings Section, you will consider ratings given by Moody's or Standards and Poor's. You should also review the ratings of A. M. Best for companies that underwrite insurance[6].

Although it is commonly thought that insurance companies make a profit only due to the difference between premium revenue and claim expenses, that if often not the case.

Insurance companies make a profit through their success at managing the funds available for investment. Insurance companies receive money from customers for premiums and management fees. The company has the funds available for investment, sometimes for many years, before claims are paid to policyholders and beneficiaries.

Ratio Analysis

Some of the ratios suggested in the Earnings Section use information from the cash flow statement. Typically, the cash flow statement is less informative for insurance companies than for other types of industries. The investment portfolio dominates assets and the management of it results in a significant volume of activity reported in the financing section of the cash flow statement. This leads to results that although typical for insurance may appear odd.

[6] Information about A. M. Best is included in Appendix C.

The current ratio cannot be used for most insurance organizations. The balance sheets for these entities are not usually segregated into current and long-term assets.

Operating cash flow is also of less importance for insurance companies again because of the significant impact of investing activities reflected in the financing section of the cash flow statement.

As mentioned previously many insurance entities have little to no debt resulting in either highly favorable or no result for the debt ratio.

Because of the high capital levels of many insurance companies, return on equity results are often lower for this industry than for other industries. Often investment analysts, due to their lack of understanding of the industry and their focus on maximizing return on equity for investors, shy away from these companies. Instead you should view the high capital level as a strength rather than a weakness.

Deferred Acquisition Costs

Deferred policy acquisition costs (DPAC) are referred to in the Earnings Section as an asset that does not generate cash. DPAC is comprised of the costs necessary to sell and issue a policy such as agent commissions and underwriters salaries and benefits. These expenses are paid early in the policy term. Under the GAAP matching concept items are expensed in the same period that the corresponding revenue is earned. DPAC is a prepaid expense (asset) that is amortized over the estimated life of the policy.

Property/casualty companies typically issue 6 month or 12 month policies. DPAC is expensed over the policy life. Given the short-term nature of property/casualty policies, DPAC does not typically represent a large portion of assets on the balance sheet.

Life insurance companies issue policies that are expected to remain in force for many years. DPAC is expensed over this estimated longer life of the policy and therefore is typically a larger percentage of assets.

SUMMARY

The insurance industry is comprised of a variety of different types of organizations. An understanding of these businesses and how they differ from thrifts will help you in determining the scope and methodology for conducting a holding company examination.

LIFE INSURANCE

The major distinguishing feature of the life insurance industry is its inherent long-term nature. The perspective of the long-term, collecting premium for many years and then paying a death benefit, impacts the approach to investing, revenue and expense recognition and regulation. The long-term nature of coverage combined with the increased risk of death as people age is distinct from the risks of other types of insurance.

Traditionally the life insurance industry focused on fixed life insurance products and fixed annuities. Products like term life and whole life are typical fixed products.

Over the past two decades, life insurance companies have focused on diversifying their revenue base by developing and selling retirement planning and asset management focused products. The inherent long-term nature of retirement planning and funding is a natural match for the industry.

The increase in stock market prices during the 1990's led to a significant shift in product sales from fixed life insurance and fixed annuities to variable life insurance and variable annuities. This shift has a material financial impact for the insurer. (Instability in the stock market that began during 2000 has resulted in a significant slowdown in sales of variable products and a renewed demand for fixed products.)

The insurer retains investment and interest rate risk for fixed products. Most variable products shift the substantial portion of investment and interest rate risk to the policyholder. Most variable products include rate guarantees set at very low levels.

In many ways, transferring risk benefits the company. However, during periods of high investment returns, the company's investment returns are less than for fixed products, where excess earnings are retained by the company.

Variable products also generate income differently than fixed products. Fixed products generate revenue through both insurance premiums and the portion of investment return that is above the fixed rate credited to the product. Variable products generate revenue through fees for insurance coverage and asset management fees for the portfolio of investments underlying the product. The shift to variable products can create a more stable revenue flow based on fee income rather than investment returns.

Typical Balance Sheet

The shift to variable products from fixed products has ramifications for financial statement presentation.

The largest asset category on the balance sheet for the typical life insurance company is cash and investments. Funds collected by insurers through the sales of fixed products fund the investment portfolio.

The majority of the general investment portfolio (about 70 percent) is invested in high quality bonds. About ten percent of the portfolio is typically invested in mortgage loans. The balance is split among common stock, real estate, cash and policy loans. States have strict investment laws limiting the percentages, and risk exposures of company investments.

Deferred policy acquisition costs consist of the expenses necessary to sell and issue a policy such as agent commissions and underwriters' salaries and benefits. These expenses are paid early in the policy term. Under the GAAP matching concept items are expensed in the same period the corresponding revenue is earned. Since these costs are paid early in the policy term a prepaid asset is recorded. The asset is expensed over the expected length of time the policy will be in force. Most types of life insurance policies remain in force for many years. Therefore, the prepaid expense (asset) is amortized over the actuarially estimated life, which may be many years. As a result DPAC

is often a material item on the balance sheet of life insurance companies.

Variable products, indexed products and some modified guaranteed products are accounted for through the use of 'separate accounts'. Separate accounts are separate line items in both the assets and liabilities sections of the balance sheet. The amounts should be comparable.

Separate accounts represent segregated portfolios of assets owned by a life insurance company. The accounts are segregated because investment experience is credited directly to the participating policies covered.

The corresponding liability recorded on the balance sheet represents the ownership interest in these funds by policyholders and beneficiaries.

Separate accounts are segregated from the balance of the investment portfolio because the assets and related investment gains and losses are insulated from the company's creditors and liquidation claims.

Due to customer interest in various sectors of the stock market, separate account investments are diverse. They are often of a higher level of risk than those in the general investment portfolio. State law allows separate account assets to be invested without the strict limitations imposed on the general investment account. Customers choose the types of investments that will be held based on their risk appetite. Separate account offerings can look similar to those of mutual funds. For example, separate accounts investments may be focused towards common stock or bonds, 'high-tech', small cap, international, growth or income focused investments.

Typically, cash, invested assets, separate accounts and deferred policy acquisition costs will account for the majority of total assets. The remaining amounts are spread among a variety of accounts depending on the types of business in which the company is involved.

The majority of liabilities are spread among a variety of accounts that represent reserves for current or expected future claims. These reserves are actuarially determined based upon estimates of mortality, morbidity and longevity. Reserves for life insurance policies begin to be accumulated once the policy is sold, and increase each year. As mentioned previously, separate accounts have both an asset and a corresponding liability.

A life insurance company's counterpart to retained earnings is called surplus. At the time of publication the industry is strongly capitalized with surplus supporting about seven percent of total assets.

Risk-Based Capital (RBC) Requirements

As noted in Section 930, state insurance regulators measure an insurance company's capital by its risk-based capital ratio. The ratio is total adjusted capital divided by authorized control level risk-based capital.

The life and health insurance risk-based capital formula considers the four major risk categories of:

- Asset risk – the risk that an insurer's assets will default or decline in value.
- Insurance risk – the risk related to improper underwriting assumptions
- Interest rate risk – the risk of changing interest rates on assets and liabilities
- Business risk – other risks not included in the other three categories.

Risk-based capital results for life and health insurers are evaluated at various levels:

- 250% and above – adequate, no further action required.
- 200-249% – trend test level, a trend test is conducted to determine if an adverse trend exists. An adverse result requires the insurer to file an RBC corrective plan with the state. A favorable trend result requires no further action.

- 150-199% – Company action level, a corrective plan is required.
- 100-149% – Regulatory action level, appropriate examination procedures are required with corrective actions implemented.
- 70-99% – Authorized control level, a commissioner may take action against the company.
- Below 70% – Mandatory control level, the commissioner must seize the company unless there is a reasonable expectation that the condition will be resolved within 90 days.

Typical Income Statement

Under statutory accounting a life insurance company income statement is called a summary of operations. Given the more conservative nature of statutory accounting revenue tends to be recognized at the later of earned or received and expenses at the earlier of accrued or paid.

The statements shows various expensed amounts related to policy reserves. These are amounts recorded at actuarially determined periods throughout the life of the policy, not at the time of policy payment.

The life insurance industry does not have a counterpart to the combined ratio. However, for traditional fixed life insurance products and fixed annuities, the concept is similar although the time period may be even longer.

For fixed return products, the life insurance company receives the premium and invests the funds until policy benefits are paid to beneficiaries many years later. The company's success is measured by its ability to generate higher investment returns than the return guaranteed under the product.

The model is different for variable return life insurance and annuity products. Insurance companies charge a fee for the life insurance coverage provided by the product and in addition, charge a fee for the management of the underlying investment portfolio. This management fee makes up for the loss of the excess investment return earned on fixed products.

PROPERTY/CASUALTY INSURANCE

Property/casualty insurance companies are in the business of accepting the transfer of risk of financial loss from policyholders. Customers transfer the risk of loss, or decrease in value of automobiles, homes and other property as well as the risk of financial loss due to damages done to others (casualty losses).

A major factor impacting property/casualty companies is their exposure to catastrophe losses. Catastrophes are a single event that results in insured losses (to the industry) of $25 million or more. Most are weather related but they can result from other manmade events as well.

Although catastrophes are normal, expected events, they cannot be eliminated, controlled or accurately predicted with any large degree of reliability. For example, no one knows how many hurricanes, of what intensity and geographic course will occur in a season.

The exposure to catastrophe losses has significant repercussions in the way companies select, underwrite and price policies. It also impacts the degree of reinsurance needed to manage the business and the investment goals in managing the portfolio.

Catastrophes are easily understood to impact property insurance. Damage to homes, cars and commercial buildings by major weather events are often seen on the evening news. However, catastrophes also impact casualty insurance. For example, a hurricane that reaches an area during business hours may result in injuries to employees covered by workers' compensation insurance, customers of businesses covered by general liability insurance, and the general public injured by flying property and debris also covered by various types of liability insurance (both personal and business insurance).

Another major factor affecting property/casualty insurance is the short-tail or long-tail nature of the various types of insurance business. Short-tail lines of business are those where claims are paid within a short period of time after the loss occurs. Minor auto accidents that do not result in injuries are an example of this. Property insurance coverage is typically short-tail business.

Long-tail lines of business are those that take many years to resolve. Many casualty lines of business are long-tail lines of business. Medical malpractice insurance for pediatricians is a long-tail line of insurance. Laws allow claims to be brought by parents. However, the laws also allow the child to bring their own actions upon becoming an adult. The time between notice of a potential claim and final resolution may span decades in this type of insurance.

The potential time spans in resolving claims has serious ramifications in the company's investment strategy both in terms of risk and durations.

One of the ways in which property/casualty insurance differs from life insurance is in the duration of the policy.

Most property/casualty policies are written for a term of one year. Some companies still issue personal automobile insurance policies for 6 months. Life insurance policies are expected to span many years. This difference in term impacts financial statements.

Just as with life insurance companies, property/casualty companies are in the business of collecting premiums and fees, investing the funds and paying claims to policyholders and claimants.

For a claim to be covered by the policy it must occur during the policy period, regardless of when the insurance company is notified. The loss to the policyholder must also be from a cause of loss covered by the policy. It must also not have occurred as a result of an act of the policyholder intending to cause a loss.

Although a policy may be in force for 12 months, losses that occurred during the policy may be paid out over many years. For example, a person injured in an automobile accident may require medical treatment for many years. If a covered loss occurred during the policy term, expenses will be paid, many years later, up to the policy limit, even though the policy has long expired.

Typical Balance Sheet

As with life insurance companies, the largest asset category for property/casualty insurance companies is cash and investments. However, because property/casualty companies do not have separate accounts business a larger portion of total assets is in this category. Typically this category accounts for about 88 percent of total assets. Bonds are the largest portions of the portfolio. Typically bonds are about 65 percent of the total portfolio. Bonds are valued at amortized cost.

Common stock is the second largest component of the portfolio accounting for approximately about one quarter of the typical insurers investment portfolio.

The remaining 12 percent of total assets are spread among a variety of accounts including amounts due from agents for payment of policies and amounts due from reinsurers.

Property/casualty companies have built substantial amounts of retained earnings over the years. Property/casualty companies call retained earnings, capital stock and other amounts policyholders' surplus. Low catastrophe losses during the last half of the 1990's, strong investment results and judicious use of reinsurance have increased the level of surplus by the end of the decade. Recent events may result in decreased surplus for certain affected companies. The industry is expected to remain well capitalized.

The largest portion of liabilities is in accounts related to claim reserves. These accounts include reserves for the payment of claims as well as those for payment of expenses incurred in investigating and administering claims. Claim related reserves have decreased as a percent of assets over recent years not due to changes in loss patterns but due to strengthened surplus.

Risk-Based Capital Requirements

As noted in Section 930, state insurance regulators measure an insurance company's capital by its risk-based capital ratio. The ratio is total adjusted capital divided by authorized control level risk-based capital.

The property/casualty risk-based capital formula considers the four major risk categories of:

- Investment risk – the risk that an insurer's assets will default or decline in value.
- Credit risk – the risk of default by agents, reinsurers and other types of creditors.
- Underwriting risk – considers the risk of adverse reserve development as well as the risk of inadequate rates.
- Off-balance sheet risk – the risks of excessive growth and contingent liabilities.

Risk-based capital results for property/casualty companies are evaluated based upon:

- 200% and above – Adequate level, no further action.
- 150-199% – Company action level, a corrective action plan is required.
- 100-149% – Regulatory action level, appropriate examination procedures and corrective action plan are required.
- 70-99% – Authorized control level, a commissioner may take action against the company.
- Below 70% – Mandatory control level, the commissioner must seize the company unless there is a reasonable expectation that the condition will be resolved within 90 days.

Typical Income Statement

A property/casualty company's financial success at underwriting insurance policies is measured through the combined ratio. This ratio measures the proportion of earned premium remaining after claim costs are incurred and the proportion of written premium remaining after the expenses of selling and issuing the policy. The industry typically has a combined ratio result slightly above 100. A combined ratio of 100 means that claims and expenses equal premium. In other words, underwriting results are at breakeven.

TITLE INSURANCE

Title insurance guarantees a clear title to real property. The policy is issued at the time of transfer or sale. Title insurance is a product that seeks to eliminate the risk of loss before the transaction by identifying any liens or judgments that would prohibit the transfer of a clear title. This differs from other types of insurance that reimburse for incurring a loss.

Title insurers, by researching the property history, identify potential problems thereby allowing a property purchaser to change the purchase decision or resolve the problem prior to purchase. It that way they seek to prevent claims from occurring. This differs from other types of insurance. For instance, a typical homeowners insurance policy does not prevent a fire from occurring, rather it reduces the potential financial impact to the homeowner should a fire occur.

Title insurance companies have a different business model than other types of insurance. Most insurers collect premium and incur the majority of their expenses (claims and claim adjustment) after the policy is effective. Title insurers historically have extremely low loss ratios (typically well below 20 percent) but incur the bulk of expenses prior to the effective date of the policy. Title insurers are in the business of risk elimination, not loss payment.

The effective date of the policy is typically the date of purchase. Prior to that time the title insurer engages in extensive and detailed investigation of the ownership history, filed liens and encumbrances on the property. The intent is to assure passage of a clear title. The difference in the business model results in some differences

in the types of items shown on the company's financial statements.

Typical Balance Sheet

The balance sheet reflects an asset "Title plants and other indexes" which reflects the accumulated value of all the properties researched over the years. The title plant is an asset whose value is based upon the ability to reuse that information and update it the next time the property is sold or transferred.

A title insurer will typically show the title plant as the third largest asset behind cash and investments. This long-term asset is not depreciated because the knowledge is not expected to decline in value over time.

Title insurance companies are not subject to risk-based capital requirements. Instead, each state requires that a minimum dollar amount of capital be held.

Typical Income Statement

Because title insurers focus on preventing claims, expenses related to payments under the policy terms are not the largest expense. Rather, administrative expenses to research titles, maintain the title plant and issue title policies account for the majority of expenses.

Claims do occur however, in spite of best efforts to prevent them. About 20 percent of premiums earned are eventually paid out in claims.

Title insurer profits can be more erratic than for other types of insurance. Title insurance is directly tied to the strength of the housing market. Increasing mortgage rates or recessions can slow home sales resulting in fewer title insurance policies being sold. Decreasing mortgages rates or economic recoveries can increase home sales and refinancing resulting in significant increases in title policies sold.

PRIVATE MORTGAGE INSURANCE

Lenders require private mortgage insurance (PMI) when the mortgage loan is for more than 80 percent of the appraised value of the home. The borrower pays for PMI but the lender is the policy beneficiary. Most borrowers obtain PMI coverage from the company offered by the lender although they have the option of obtaining it elsewhere.

Traditionally, the institution received a fee for each PMI client successfully referred to the PMI carrier. Over the last several years, thrift holding companies have established reinsurance subsidiaries to underwrite PMI reinsurance. The subsidiary typically provides PMI reinsurance only for a PMI carrier offered by the lender and for loans it originates.

Institutions and their holding companies have expanded their involvement into reinsurance for several reasons. Reinsurance premiums increase revenue. Lending also becomes more effective as the revenue generated from each loan increases. PMI also diversifies the sources of revenue generated within the structure by generating fee income rather than interest.

PMI companies have marketed this approach to institutions for several reasons. The participation of the institution in the risk of default is thought to strengthen the institutions risk selection process. The institution also shares in the risk of loss by providing reinsurer to the carrier.

PMI reinsurance is typically structured in one of two ways. The reinsurer may provide participating coverage of a certain percentage of each claim. A participating program results in the institution being financially responsible for a predetermined percentage of each claim.

More commonly, the reinsurer provides a set portion of excess coverage. Excess coverage is described in terms of 'layers' that stack on top of each other. Under excess coverage, the PMI carrier accepts the initial layer up to a predetermined dollar amount or percentage of covered loans. After that limit has been reached, the next layer of

coverage is activated. Claims in this layer are those usually covered by the reinsurer. Typically, the reinsured layer has both a floor and ceiling. The floor is the initial amount that must be paid by the PMI carrier before the reinsurance assumes any claims. The ceiling is the maximum amount covered by the reinsurance. Typically, after the ceiling has been met, the PMI carrier pays any additional claims.

Although the possibility of claims must exist for the program to be considered reinsurance, the expectation is for claims to rarely reach the layer of reinsurance coverage.

The PMI industry estimates claims rates at two percent to six percent of covered loan amounts. Actual results depend on economic factors and lending criteria. Reinsurance agreements are typically structured to begin at a percentage of loss greater than what would normally be expected from underlying loans.

INSURANCE AGENCIES AND BROKERS

Either agents or brokers can sell insurance. Agents work on behalf of the insurance companies they represent. They may be employees of the insurance company or they may be independent business people who choose to represent the insurance company.

Independent agents work on behalf of insurance companies but are independent businesses. They typically represent many different companies. Their competitive advantage is their ability to offer customers an array of products from various companies to meet their insurance needs. The insurance companies that they represent pay them commissions. Most companies also supplement agent compensation with bonuses based on growth and profitability.

Captive agents work on behalf of a single insurance company but are independent businesses. To the public they may appear to be employees of the insurance company. Their competitive advantage typically rests in the strong brand name and market presence of the insurance company they represent. Insurance companies that market through captive agents typically support the agents through strong training programs, advertising support and administrative programs. Captive agents are paid commissions often supplemented by growth and profitability bonuses.

Agents who are employees work for a single insurance company. They may work in a locations separate from the company offices. They are often paid a small base salary supplemented by commissions. Office administration, advertising, marketing, sales volumes and types are usually strictly controlled by the company.

Brokers represent customers rather than insurance companies. Their role is to bring together the buyer with appropriate insurance companies, analyze coverage needs and make recommendations. They are independent businesses. They are paid through commission. Some insurance companies do not pay growth and profitability bonuses to brokers, others do.

Agents and brokers must be licensed by each state in which they sell insurance. Most states require continuing education in order to renew licenses.

Historically, licensing requirements varied widely from state to state. Gramm-Leach-Bliley proposed the creation of the National Association of Registered Agents and Brokers (NARAB). Under this law NARAB would come into effect to create uniformity in agent and broker licensing unless a majority of the states enacted conforming legislation by November 12, 2002. A majority of states have passed laws that provide for reciprocity, a first step towards consistency.

Agents and brokers do not use SAP. Agents and brokers that are privately held may create cash basis or tax basis financial statements.

Agents and brokers are not required to file financial statements with the department of insurance. The department has the authority to request them at any time.

Sales of insurance products by thrifts, or on behalf of thrifts to consumers are regulated by 12

CFR Chapter V Part 536 Consumer Protection of Sales of Insurance. The rule became effective October 1, 2001. It implements requirements of Gramm-Leach-Bliley.

REINSURANCE

Reinsurance is insurance for insurance companies. Property/casualty companies use reinsurance more extensively than life insurance companies. An insurance company that sells its products to the public may also be a reinsurer for other insurance companies. There are also companies that only sell reinsurance.

Reinsurers are regulated less rigorously than insurance companies that deal with the public. Both parties in a reinsurance transaction are assumed to be knowledgeable in insurance and are therefore better prepared to protect their interests.

Reinsurance can be issued either for one policy (facultative) or for a group of many similar policies (treaty). Facultative reinsurance is used for large, complex, individualized policies. For instance, a large casino, horse racetrack and hotel complex with one owner would be more appropriately handled through facultative reinsurance.

Treaty reinsurance is typically used for types of business where many similar policies are issued. For instance, treaty reinsurance is very common for private passenger automobile insurance, homeowners insurance and small business insurance.

Insurance companies use reinsurance for several reasons. Property/casualty companies can use reinsurance to spread risk related to geographic concentrations. Companies with heavy concentrations of policyholders in locations exposed to weather catastrophes may choose to reinsure a potion of the business to reduce the risk of loss.

The purchase of reinsurance results in the receipt of a commission for producing the business. Reinsurance commissions flow into revenue thereby reimbursing a portion of the expenses incurred to generate sales. As discussed previously, under SAP, policy acquisition costs are immediately expensed. Reinsurance commissions offset a portion of these expenses.

Reinsurance can also be used to stabilize underwriting results by moving a portion of the risk to another insurer. Companies often reinsure particularly high-risk accounts, whether large, complex property/casualty accounts or large life insurance policies. Reinsuring the risk reduces the amount of the claim that will be incurred when an insured event occurs.

Companies also can obtain reinsurance when they would like to exit a line of business. A substantial reinsurance program can minimize the exposure of the company to the results of that business segment.

SUMMARY

Although part of the financial services industry, insurance operates differently than thrifts in many ways. A basic understanding of the industry can help you to identify potential problem areas and more effectively plan examination steps for insurance holding companies.

INTRODUCTION

Insurance regulation is conducted at an individual state level. Each insurance company has a domiciliary or home state. This is the state in which the company has its corporate charter. This state is the primary regulator of the company.

The mission of state insurance departments is to protect consumers and maintain a healthy industry. This mission is accomplished through a focus on financial solvency of companies and market conduct activities. (The term 'market conduct' is comparable to the OTS term 'compliance'.)

Insurance departments have authority to conduct examinations of any insurance company doing business in the state regardless of where the company is domiciled. Often states work together to conduct examinations of multi-state companies.

State insurance department reports are public information in many states. OTS has entered into information sharing agreements with many states to obtain access to examination reports. Your regional functional regulation coordinator can assist you in obtaining these reports.

Insurance department examination reports (both financial and market conduct) should be requested from the domiciliary state. You should evaluate these reports to determine any potential impact on the holding company or thrift.

STATE STRUCTURE

Companies must be licensed in each state in which they want to sell their products. Most large companies are licensed in each of the lower 48 states and the District of Columbia and often Alaska and Hawaii. (Because Alaska and Hawaii present unique geographic challenges some companies choose not to do business there.) Each state in which a company is licensed also has authority to regulate the company for activities within that state.

Most insurance holding companies own multiple insurance companies. They may all be domiciled in the same state or they may each be domiciled in a different state. In addition, each company may be licensed to do business in a variety of states.

In addition to chartering (domiciliary state) and licensing, states regulate other insurance activities as well. Policy forms, endorsements[1], riders[2] and rates (property/casualty insurance) are subject to regulation as well.

DEPARTMENT STRUCTURE

Most state insurance departments operate as a separate department within state government. In some states, regulation of all financial services has been centralized in one department. In those states the same department or agency regulates insurance, banking and securities with separate sections specializing in each. The departments in Vermont and New Jersey are two states that operate this way.

State insurance departments vary in size from less than 30 to over 1,000 employees. As a result, functions are handled differently from state to state. However, there are several common functions that are performed by all departments:

- Financial condition examinations
- Market conduct examinations
- Financial analysis
- Company licensing and admissions
- Consumer affairs
- Enforcement

[1] Endorsements are forms used to change a standard property/casualty policy to reflect the needs of the policyholder.

[2] Riders are forms used to change a standard life insurance policy to reflect the needs of the policyholder.

- Policy and forms analysis
- Rate filings
- Agent licensing
- Legal

In some smaller states, the same people may perform several functions, such as financial condition examinations and financial analysis. In other, larger states, employee responsibilities are more specialized.

Insurance companies receive the most structured and intensive regulation. In addition to financial and market conduct activity, policy forms, rates and advertising are subject to regulatory oversight.

Pure reinsurers receive significantly less oversight because they do not deal with the general public. These companies deal only with other insurance companies. Both the reinsurer and its insurance company customer are considered to be knowledgeable and less in need of protection.

Due to the large number of agents and brokers, regulation is handled in a different way. All states require licensing after successful completion of an examination. Most states also require continuing education in order to renew licenses.

Although state insurance departments have the authority to conduct financial and market conduct exams of agents at any time, they do not happen on a regular schedule. Most regulation for this group centers on the investigation of consumer complaints. A high frequency of serious complaints or severity of a given complaint may result in either a financial or market conduct examination.

Financial examinations occur every three to five years depending on state law. Most states do not have a specific requirement for the frequency of market conduct examinations. In small states, market conduct examinations are done through complaint investigation.

Insurance regulation historically varied greatly from state to state. During the last decade efforts have been made to strengthen and standardize insurance regulation and procedures from state to state. The passage of Gramm-Leach-Bliley in 1999 increased states efforts in these areas.

State insurance departments are funded in a variety of ways. Insurance department sources of revenues are premium taxes, audit fees, filing fees and licensing fees. In some states, the department receives revenues with the balance in excess of the budget forwarded to the state general fund. In other states, the state treasury receives insurance department revenue, with the department receiving its fund allocation. In general, less than ten percent of the revenue collected by the department is spent on insurance regulation.

GUARANTY FUNDS

Unlike thrifts, insurance companies failures are not covered by any government funded (either federal or state) insurance program.

Insurance companies failures are paid for by the other insurance companies selling business in the state. The mechanism to collect the funds and handle insolvencies is the state guaranty fund. Separate funds exist in each state, one each for property/casualty and life/health insurance.

Guaranty funds step in to make up state mandated shortfalls that may occur in company failures. Typically, policyholders are notified of the date coverage will terminate and their need to find coverage elsewhere. Claims are paid in full, up to a certain dollar amount, depending on the state and type of policy. Most states have maximum amounts per policy that are covered by the funds.

Guaranty funds are not prefunded. Once a state places a company into receivership the guaranty fund steps in. The fund works with the court appointed receiver to determine an estimated shortfall.

Insurance companies who write the same types of insurance in the state are subject to assessment for the failure. Each company is billed in relation to the amount of business it writes in the state. For instance, if an auto insurer is taken into receiver-

ship, the insurance company writing the most automobile insurance in the state will be assessed the largest amount. Receiverships can take many years to resolve.

The Federal Insurance Deposit Corporation (FDIC) advertises the insurance it provides to depositors. State guaranty funds do not. In many states agents are prohibited from discussing the existence of guaranty funds during the sales process. State regulators do not want to encourage consumers to rely on the existence of the fund instead of making informed purchase decisions.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)

The NAIC, formed in 1871 is a voluntary organization of the chief insurance regulatory officials of the 50 states, the District of Columbia, American Samoa, Guam, Puerto Rico and the Virgin Islands. The purpose of the NAIC is to assist state insurance regulators in their mission of adequately regulating the insurance industry. The organization focuses on issues that protect consumers and help maintain the financial stability of the insurance industry.

The NAIC is comprised of insurance commissioners and their staff as well as a paid staff of NAIC employees. The organization develops model laws, financial analysis tools, statutory accounting principles, market conduct regulations and examination programs and practices.

The NAIC conducts its work through an elaborate system of committees, working groups and task forces. Groups can be disbanded once objectives are accomplished and new groups are created as issues arise in the industry. At any point in time the NAIC has over 150 different groups in place.

The groups conduct their work through conference calls and meetings. The NAIC meets formally on a quarterly basis to report on its progress and agenda. Most meetings are open to the public.

NAIC MODEL LAWS

The development of model laws is a key contribution of the NAIC. A model law is a draft bill that may be submitted to state legislature. States may modify model laws to meet their specific needs. Model laws typically include input from many states providing the benefit of diverse practices and real world experiences. States have the option of whether or not to use the model laws. State legislatures must pass the law in order to make it effective in the state.

NAIC DATABASE

The NAIC maintains the largest database of insurer financial information in the world. Companies required to file statutory financial statements by the state are usually also required to file the statements with the NAIC. The information becomes part of a database that is used as a basis for examination preparation and financial analysis.

NAIC SOLVENCY AND MARKET CONDUCT PRODUCTS

The NAIC also provides the states with standard financial examination, market conduct, financial analysis and other programs and handbooks, all supported by automated tools and training programs.

Smaller insurance departments are able to use the NAIC manuals and automated tools as a complete system for examinations and analysis. Larger departments often modify the products to meet specific state requirements and staffing needs.

In addition, NAIC staff is available to consult on unusual or complex topics that arise during the course of regulatory activities.

ACCREDITATION PROGRAM

In 1990, the NAIC implemented the Accreditation Program. This program includes the baseline

standards for solvency regulation by state insurance departments. The goal of the program is to improve the quality of regulation. The program includes a mandatory full on-site examination and re-accreditation of the department every five years with interim annual reviews to assure compliance with standards. Departments with inadequate regulations or procedures may lose accreditation. A map showing the current accreditation status of each state is available on the NAIC website (www.naic.org).

Accreditation standards require that insurance departments have adequate statutory and administrative authority to regulate an insurer's corporate and financial affairs. The program also evaluates the adequacy of staff, both in quantity and quality. In addition, the administrative, organizational and personnel practices are reviewed to determine that the department has the organizational ability to be effective.

Accreditation standards include required financial examination procedures and practices, personnel standards and the adoption of certain model laws by the state legislature.

STATUTORY ACCOUNTING PRINCIPLES

Statutory Accounting Principles (SAP) are the accounting rules and methods required by state insurance departments for insurance companies. SAP differs greatly from Generally Accepted Accounting Principles (GAAP).

Differences Between SAP and GAAP

SAP is balance sheet oriented with the emphasis on valuation of assets and liabilities on a liquidation basis. This is quite different than GAAP that has an income statement focus and assumes a going concern and the matching of income with related expense.

SAP is less concerned with matching income and expense time periods and instead recognizes expenses more aggressively and income more conservatively.

SAP is intentionally more conservative than GAAP. It values assets at amounts that could be realized quickly and liabilities at amounts required to satisfy them as though they were immediately due and payable. Because of this sense of immediacy, SAP statements do not use the traditional current and long-term categories often seen on GAAP statements.

An asset under SAP is only an asset if it has been specifically identified in SAP as an asset. Any GAAP asset that is not recognized by SAP is considered a nonadmitted asset. Because total GAAP assets are reduced by the value of nonadmitted assets to reach SAP assets, policyholders' surplus (owners' equity in GAAP) is also reduced by an equal amount.

A nonadmitted asset is an item that does not meet the strict requirements of liquidity for SAP. Examples are, company office buildings, furniture, fixtures, supplies, prepaid expenses and uncollected premiums more than 90 days old. These items are nonadmitted for SAP because it would be difficult to convert them into cash in a short period of time without a loss in value.

SAP also differs from GAAP in its more strict rules for the financial statement recognition of reinsurance, deferred taxes and premium deficiencies.

Because companies are regulated individually by states, SAP is focused on an individual insurance company presentation of results. Unlike GAAP, the concept of consolidated statements does not exist. Combined statements for a group of property/casualty insurance companies can be prepared but may not be all inclusive of all entities in the organization. Combined statements are not prepared for other types of insurers.

The NAIC's role in SAP

SAP is promulgated by the NAIC and is published in its Accounting Practices and Procedures Manual. This manual is for sale to the public. Changes to SAP are typically adopted as of January 1 of the year.

SAP stands separate and apart from GAAP. It has not received Other Comprehensive Basis of Accounting (OCBOA) standing from the American Institute of Certified Public Accountants (AICPA).

A standing committee of the NAIC is charged with reviewing changes to GAAP to determine the applicability and impact on SAP. This is done to address new developments in the world of financial reporting but is not done with the intent that SAP be changed to match GAAP.

SAP statements are prepared on NAIC standard forms called blanks. Statements are prepared for the first three quarters and at year-end. All companies report based upon calendar quarters and a December 31 year-end. The year-end blank is much more detailed than the quarterly blank.

Statutory Financial Statements

SAP statements include a balance sheet, income statement and cash flow statement. In addition, a number of schedules present detailed information regarding investments, claims and reinsurance.

Each major insurance industry has its own specific blanks version. Separate versions exist for property/casualty, life/health, health maintenance organization, dental plans, fraternal organizations and title insurance.

Prescribed and Permitted Practices

The NAIC prescribes SAP. State insurance departments, as the regulatory authority, continue to have the ability to grant companies permission to deviate from SAP. State approved deviations from SAP are considered permitted practices. Companies must include in the Notes to the Financial Statement permitted practices and their impact.

State insurance departments grant a permitted practice for an individual company when prescribed SAP would result in financial reporting that would be inappropriate or misleading for the situation.

SUMMARY

The insurance industry is regulated primarily at the state level. The insurance regulators of the 50 states, the District and the 4 territories developed methods of communicating and coordinating activities through the NAIC and informal channels of communication. This cooperation and communication has resulted in a regulatory system and structure that is consistent in many ways while still providing states the ability to address local concerns.

A. M. BEST

The A. M. Best (Best) Company is a widely recognized, and highly regarded firm that analyzes and rates insurance companies. Best has been publishing ratings of insurance companies since 1906.

Independent ratings are an important indicator of company solvency and financial condition. Best's ratings provide an independent opinion of an insurance company's ability to meet policyholder obligations (claim payments). Those evaluating a company or marketing relationship can use these ratings to identify concerns of a financial nature.

Best's information, consistent with state insurance regulation, is on an individual insurance company basis. The ratings do consider the impact of other companies in the structure, and the impact the holding company may have on the rated company.

Best ratings are available to the general public free of charge. The easiest way to obtain these ratings is through the Company's website www.ambest.com. Ratings can be obtained by entering the company name. Ratings for other companies in the group are also available.

There are 16 major letter ratings divided between the following two broad categories:

Secure – (strong ability to meet ongoing obligation to policyholders)

A++ and A+	Superior
A and A-	Excellent
B++ and B+	Very Good

Vulnerable – (good ability to meet ongoing obligations to policyholders)

B and B-	Fair
C++ and C+	Marginal
C and C-	Weak
D	Poor
E	Under Regulatory Supervision
F	In Liquidation

To obtain an alphabetical Best's rating, an insurance company must have a minimum of five consecutive years of operating results, be of a certain size, provide the required financial and operating information and pay a fee.

In addition to the letter rating, Best assigns a rating outlook to most companies. The outlook provides a sense of potential future direction for the company over the next 2 to 24 months. The indicators can be described as positive, negative or stable based upon expected business trends.

The process employed by Best is based on analysis of Statutory Accounting Principles (SAP) financial statements. This is supplemented with Generally Accepted Accounting Principles (GAAP) audited financial statements and SEC filings (where available), and other information. In order to receive a letter rating, Best must have the ability to conduct ongoing discussions with managements.

Best reviews and updates the ratings of each company at least annually. Reviews outside of the annual cycle are triggered by events that may materially impact the company. Examples of these events include: acquisitions, mergers and sales, major changes in reinsurance programs, demutualization, catastrophes, significant financial concerns regarding an affiliate, parent or subsidiary, significant changes in regulations or legislation, or unexpected changes in earnings.

OBTAINING INFORMATION

To facilitate your understanding of insurance enterprises with thrifts within the structure, you should review the Best rating. A review of the Best rating and the supporting analysis will aid you in identifying potential areas of concern in the examination process. It will also provide perspective on the current state of the insurance operation and its outlook in the near term.

Best ratings can be supplemented by obtaining a detailed company profile. These profiles contain a history and analysis of each company. Profiles can be ordered through the Best website. The profile is delivered to you through e-mail in a matter of minutes.

Individual company profiles cost $35 per company. Most insurance structures are comprised of several, sometimes, many, individual insurance companies. Requesting profiles for all the companies is typically not necessary and may be cost prohibitive.

In order to make the best use of funds, you may want to obtain profiles initially only for the largest companies in the structure. Going forward you should then consider obtaining profiles for any company in the enterprise with a rating in the vulnerable category or for any company with a significant rating decline.

OTS has established a prefunded account for staff to obtain these reports. The Manager of Information Services Branch in Washington administers the OTS account. Your region can forward the names of authorized users to Washington so that access can be established.

SUMMARY

Best's has a long history and is highly regarded in its ability to evaluate insurance companies. Your use of Best information can help you in identifying areas of concern and in developing the scope of holding company examinations.

INTRODUCTION

A conglomerate is generally defined as a corporate enterprise made up of a number of different companies, or legal entities, that operate in diversified fields. Some of our large and complex holding company enterprises (Category II) fall in this category. Often, conglomerates are highly integrated and managed differently than a more traditional holding company – with less regard for separate corporate existence and more focus on, for instance, product lines or geographic areas. Such functional management allows enterprises to take advantage of the synergies among their components, to deliver better products to the market, and to provide higher returns to stockholders.

This shift from managing along legal entity lines to functional lines means that the information and conclusions drawn during the examinations of individual entities within the conglomerate may be incomplete unless understood in the context of the examination findings of other related legal entities or centralized functions. In short, we must think along functional or centralized lines in order for the examination process to match the business practice. Therefore, it is appropriate to consider a broad scope of intra-group transactions, as well as risk concentrations across company lines. Furthermore, while the thrift and other regulated financial activities may have capital adequacy guidelines, as emphasized in Section 300, the capital adequacy of the consolidated holding company enterprise must also be evaluated.

This Section will provide you with a better understanding of the additional areas to consider within each CORE component when you examine a conglomerate. You should consider this guidance in connection with your examination and ongoing supervision of large and complex holding company enterprises that engage in multiple lines of business. This would typically include diversified holding companies, or holding companies that control numerous different legal entities engaged in lines of business that cross traditional sectors. A joint decision will be made by senior management in DC and the region as to whether a holding company enterprise is: 1) a conglomerate subject to the guidance contained in this Section; and 2) a conglomerate subject to a directive issued by the European Parliament and the Council of the European Union (see Appendix A).

ONGOING SUPERVISION AND USE OF SUPERVISORY PLANS

The complexity of the conglomerate will mean that we need to approach supervision differently. The rapidly changing environment of a conglomerate means that we will need to increase planning and offsite monitoring. Ongoing supervision allows for timely adjustments to our supervisory strategy as conditions change within the organization or the economy. To be effective, our supervisory efforts must be flexible and responsible. The supervisory process needs to be dynamic and forward looking in order to respond to technological advances, product innovation, new risk management systems and techniques, changes in markets, and the financial condition and operating performance of entities within the conglomerate.

We will use a more formalized annual supervisory planning process in supervising conglomerates. This process will be documented in a customized Supervisory Plan. The Supervisory Plan will serve to focus our efforts on major areas of risk, particularly those that may not be subject to full review by other regulatory authorities. In addition, the Supervisory Plan will outline our expectations with respect to reporting requirements, especially as they relate to risk concentrations, intra-group transactions, and capital adequacy. The goals and expectations outlined in the Supervisory Plan must be communicated to management to ensure that they understand the regulatory scheme in place for their organization and that OTS has their full cooperation.

In all likelihood there will be other regulators that have a supervisory role with respect to entities in the conglomerate. If there are other regulators, we will need to work closely with them to ensure that our combined supervisory efforts are seamless,

regulatory burden is reduced, and duplication is avoided. In this regard, you should get input from supervisors responsible for significant regulated entities when formulating the Supervisory Plan.

The Administration section outlines the functional regulation procedures. In addition to coordinating with fellow U.S. financial regulators, in many conglomerates you may also need to communicate with financial regulators or nonfinancial regulators in other countries.

The first step is to identify and establish communication with other interested regulators. Once you have done so, you should establish acceptable procedures for sharing information, as well as a general understanding of what types of information you will exchange. Depending on the regulator, a formal information sharing agreement may exist. To most effectively supervise the conglomerate, you should ask the other regulators for their supervisory assessment of the entity(ies) that they are primarily responsible for, as well as the nature of any major sanctions or supervisory measures they have deemed necessary.

As the group-wide regulator of the conglomerate, we should share the following:

- An organizational chart or similar summary of the major entities in the conglomerate that also identifies other regulators and their point of contact. This step will facilitate communication between interested regulators, as well as give other regulators the opportunity to verify the accuracy of your assessment of the major entities in the conglomerate.
- A list of major shareholders and managers that exercise significant influence in the conglomerate.
- The strategic policies of the conglomerate. This will allow each interested regulator to assess the impact of the conglomerate's policies on their relevant regulated entity.
- Your conclusions about the financial condition and capital adequacy of the conglomerate.
- Any significant risk concentrations or intra-group transactions that may raise supervisory concern.
- Assessment of the capability and effectiveness of management.
- Your assessment of the adequacy of risk management and internal control systems of the conglomerate.
- Any developments with major entities in the conglomerate (including the thrift) that may adversely impact other entities in the enterprise.
- Much of this information will be contained in the holding company examination report. You may share your supervisory findings with other supervisors. These conclusions should be presented to the other regulators using the Conglomerate Supervisory Review format. You will draw much of the information needed to complete the Review from the holding company examination report. Examination conclusions should be summarized in the review.

The guidance in this Section will help you assess the risks that are unique to a conglomerate. The following discussion outlines elements that you should consider in each CORE component of the holding company examination.

CAPITAL

One of our most important functions is to ensure that a conglomerate maintains adequate capital to support its risk profile and that it meets the minimum regulatory capital standards of any regulated financial sector (banking, insurance, or securities). Your review on a group-wide basis does not diminish the need for functional regulators to maintain and monitor regulated entities' compliance with the sector's requirements. The reason for conducting a capital analysis at the conglomerate level is to identify, and, if necessary, address concerns of large intra-group holdings of capital that cause difficulties in one entity to be transmitted to other entities within the group.

Your main goal is to assess capital adequacy on a group-wide basis and identify instances of double or multiple gearing that can overstate group-wide capital. You must also identify minority interests and quality of capital issues that will impact your capital analysis. A group-wide analysis will require you to consider the entire conglomerate, including both regulated and unregulated entities. While the capital requirements for regulated entities such as banks, insurance companies, and securities firms, are explicit, you will need to develop a notional capital proxy for unregulated entities based on the most analogous capital rules for a regulated entity. For instance, the regulatory capital standards for a banking company could be used to develop a notional capital proxy for a leasing company. If you cannot develop a notional capital proxy for an unregulated entity, then you should deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital.

Definitions of regulatory capital also vary from sector to sector. For instance, what may constitute regulatory capital in one industry, may not be includable as regulatory capital in another industry. In those instances where surplus capital in one sector offsets capital deficits in other sectors, you will need to make a qualitative assessment as to whether that surplus capital would be includable as regulatory capital in the capital deficient sector and is transferable to that sector.

In addition, conglomerates need to have board approved capital adequacy policies in place to provide capital management guidelines to senior managers. Capital adequacy policies should address the fundamentals of capital management such as identifying appropriate levels of capital throughout the organization, how the conglomerate will raise capital when needed, dividend and share repurchase policies, and overall capital and capital allocation strategies.

A conglomerate's capital adequacy is based on the five principles discussed below. While your capital adequacy analysis will need to be based on these principles, also consider the discussion of leveraging, earnings, and cash flow analysis described in the other sections of this Handbook.

1. **Identify instances of double or multiple gearing, for example where the same capital is used simultaneously as a buffer against risk in two or more legal entities.**

Double gearing involves two entities within a conglomerate that both include the same capital in their capital bases. Typically, this involves a parent company obtaining capital that is downstreamed to a subsidiary and counted as capital a second time. Multiple gearing is another iteration of this process whereby the same capital is counted by a third company as capital. Also be aware that double and multiple gearing can occur in different forms when capital is raised by a subsidiary and then upstreamed, or a sister affiliate raises capital that is transferred to a related company through a purchase of stock or other equity instrument. Capital gearing is likely to overstate the external capital of a conglomerate, as it is double-counted through the organization. As such, intra-group holdings of capital should be excluded.

As an example, assume that a parent insurance company has available capital[1] of $1,500 with $500 invested as common stock in a wholly owned regulated bank. Also assume that the second-tier bank, with available capital of $900, invests $250 of its capital into a wholly owned regulated securities company (third-tier organization) in the form of common stock. The securities company has available capital of $500. Further, assume that the capital required levels are $800 for the top-tier parent, $800 for the second-tier bank, and $400 for

[1] Throughout this Section, the term "available capital" includes the various definitions of regulatory capital in each industry worldwide and as a description of any substitute for "regulatory capital" in unregulated industries where you need to develop a notional capital proxy. If you cannot develop a notional capital proxy for an unregulated entity, then you should deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital.

the third-tier securities company for a total of $2,000.

	Parent Insurance Company	100% Owned 2nd Tier Banking Company	100% Owned 3rd Tier Securities Company	Group-Wide Totals
Available Capital[2]	$1,500	$900	$500	**$2,900**
Capital Required	-800	-800	-400	**-2,000**
Capital Surplus / - Deficit Before Adj. For Gearing	700	100	100	**900**
Adj. for Multiple Gearing	-500	-250	0	**-750**
Capital Surplus / - Deficit After Adj. For Gearing	200	-150	100	**150**

By simply aggregating the available capital of the three entities ($1,500 + $900 + $500 = $2,900), it would appear that on a combined basis the group-wide available capital easily exceeds the capital required of $2,000. However, as $500 of the parent's available capital was downstreamed into the second-tier bank and counted by the bank as available capital, that capital is double-geared. Further, the bank's investment of $250 of its available capital in its securities company represents an instance of multiple gearing because the same funds are now being counted by three different entities as available capital. Removing the double and triple counting of capital by deducting the insurance company's $500 investment in the bank, and the bank's $250 investment in the securities company, $750 in total, the entire conglomerate maintains a group-wide capital surplus of only $150. Also note that the parent's capital surplus is reduced from $700 to $200 and the bank's capital surplus of $100 becomes a capital deficit of $150. As the example shows, the capital adequacy of conglomerates may appear significantly better before double and multiple-gearing is recognized and removed from group-wide capital.

2. Identify instances where a parent issues debt and downstreams the proceeds in the form of equity, which can result in excessive leverage.

The use of borrowings at one level of a conglomerate that is then infused to other entities as capital raises concerns about excessive leverage. Excessive leveraging can ultimately lead to concerns with meeting debt service requirements if the company's earnings and/or cash flow were to deteriorate. This is particularly an issue when the borrowing company must rely on dividends from subsidiaries or capital injections from a parent or an affiliate to service the debt. As other regulated entities generally must meet minimum regulatory capital requirements and/or where regulators have the authority to preclude dividend payments to protect the equity of the regulated entity, a source of income and cash flow for the borrowing company may become unavailable.

In addition, loan arrangements often contain covenants and restrictions that can impact a company's ability to provide cash flow support to service the debt through dividends or capital injections from other entities within the organizational structure.

[2] It is assumed for this example that available capital at the insurance company, the bank, and the securities company includes $500, $400, and $250 of general reserves, respectively. The composition of available capital may differ depending upon the regulations for each industry and in each country.

3. Identify the effects of double, multiple, or excessive gearing through unregulated intermediate holding companies which have participations in dependents or affiliates engaged in financial activities.

Your evaluation of capital adequacy for the conglomerate must also identify instances where intermediate unregulated holding companies provide capital to subsidiaries or affiliates. You will need to effectively eliminate the capital contribution of all of the intermediate holding companies in the organizational structure to deduct the impact of capital gearing.

4. Identify the risks being accepted by unregulated entities.

As unregulated entities are not required to meet regulatory capital standards, they pose a separate and distinct problem when assessing capital. The solution is to develop a notional capital proxy for regulatory capital thresholds. For unregulated entities that have activities similar to regulated entities, for example leasing, you should apply the capital requirements of the most analogous regulated industry, such as banking, to construct a notional capital proxy. If you cannot develop a notional capital proxy for an unregulated entity, then you should deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital.

Consider an example of an unregulated parent holding company with two wholly owned regulated subsidiaries (a bank and an insurance company) and one wholly owned unregulated subsidiary (leasing company). The relevant financial information and required capital levels are:

Unregulated Parent Holding Company	
Investment in Bank Subsidiary	$700
Investment in Insurance Subsidiary	200
Investment in Leasing Subsidiary	100
Equity Capital	300
Capital Required	0

100% Owned Bank Subsidiary	
Equity Capital	$700
General Reserves	100
Available Capital[3]	800
Capital Required	-100
Capital Surplus / - Deficit	700

100% Owned Insurance Subsidiary	
Equity Capital	$200
General Reserves	100
Available Capital	300
Capital Required	-300
Capital Surplus / - Deficit	0

100% Owned Unregulated Leasing Co.	
Equity Capital	$100
Notional Capital Proxy	-150
Capital Surplus / -Deficit	-50

The example demonstrates that while the regulated entities have available capital to meet their own required capital levels, the overall group is insufficiently capitalized because the parent has downstreamed capital to its subsidiaries and there is an undercapitalized unregulated leasing company within the structure of the organization. The result of eliminating the double-gearing of the capital through consolidation and identifying a notional capital proxy for the unregulated leasing company results in the group-wide capital deficit.

[3] Note that the definition of regulatory capital will vary between industries and countries. In this example, the $100 of general reserves at the insurance company and the bank are included in available capital.

Group-Wide Totals	
Equity Capital Consolidated	$300
General Reserves	200
Available Capital	500
Aggregate Capital Required	-550
Group-Wide Capital Surplus / - Deficit	**-50**

In this example, the parent holding company is unregulated and considered a shell company with its only significant assets being investments in subsidiaries; therefore, a notional capital proxy is not required. However, if this parent holding company had substantial operations, then you would also have to develop a notional capital proxy for the parent company and factor the additional capital needed into your analysis. The capital analysis method used in this example is referred to as the Accounting Consolidation method and relies on consolidation to remove double-gearing of capital through elimination of intercompany account balances and transactions. This method is explained in further detail in Appendix B.

5. Identify investments in regulated and unregulated subsidiaries to ensure that the treatment of minority and majority interests is prudent.

In those instances where parent companies control less than 100 percent of one or more subsidiaries, you will need to carefully assess each interest. You will need to determine if your assessment of capital adequacy is more representative of the associated risks by fully aggregating the interests or excluding them by pro rating the interests. In situations where the conglomerate maintains a majority ownership interest, in excess of 50 percent but less than 100 percent, full consolidation is typically required. However, full consolidation is likely to overstate capital adequacy when capital surpluses exist. If you fully aggregate the surplus capital of subsidiaries where the parent holds less than a 100 percent interest, you may overstate capital adequacy, as compared to pro rating the capital surplus based on the parent's ownership interest. Pro rating the capital surplus recognizes the minority interest holders' right to their proportionate share of the surplus capital. It is expected that you would generally pro rate surplus capital if the conglomerate's interest in an entity is less than 100 percent. Additional discussion of the prudent treatment of majority and minority interests is detailed in Appendix C.

After pro rating the capital surplus, your assessment will also need to take into account any types of restrictions on the transferability of the surplus capital in the lower tier entities. If you decide that restrictions are present that prohibit the transfer of the surplus capital, then you will need to exclude any nontransferable surplus capital from available capital. The following page discusses transferability of capital.

In those cases where the parent holds less than a 100 percent interest in a subsidiary that is capital deficient, pro rata attribution of that capital deficiency may understate the parent's obligation to provide capital. The parent may have an obligation to fund a capital deficiency in excess of its pro rata ownership interest. For instance, in the event of a capital deficit at a regulated entity in which the parent owns 60 percent of the common equity with proportionate voting control, the conglomerate's liability to fund the capital deficit may exceed 60 percent of the deficit because it is the control owner. In this instance, the parent's obligation to fund the capital call may exceed its pro rata interest in the subsidiary. It is expected that the entire capital deficit of a sector or an entity will be factored into the group-wide capital analysis, if the parent holds a majority interest.

When the conglomerate holds a minority interest in an entity, you will need to carefully analyze whether the conglomerate's interest is a controlling interest based on percentage ownership, voting rights, and any other factors. Other factors to consider would be board membership, participation in operations or policy making, and significant intercompany relationships or transactions. Normally, you should expect that only the pro rata portion of the surplus capital of the subsidiary would be

available to the parent that holds a minority interest. If the parent's minority interest in a subsidiary is such that the parent can exert significant influence and has significant exposure to risk, you should treat the interest like a majority interest. The test of significant influence and exposure to risk can generally be expected to apply to interests of 20 percent or more, but under 50 percent.

CAPITAL MEASUREMENT METHODS

There are three capital measurement methods to assess capital adequacy – the Accounting Consolidation method, the Deduction and Aggregation method, and the Book Value / Requirement Deduction method. You may also combine each of the methods to best capture the conglomerate's capital adequacy requirements. Examples of each of the methods are presented in Appendix B.

You must first understand the ownership interests of each company throughout the conglomerate before you begin your capital assessment. Understanding the structure of the conglomerate is essential to identify unregulated entities, capital gearing, use of debt downstreamed or upstreamed as capital, and partial ownership interests. The availability of information, consolidated or unconsolidated, may dictate which capital measurement method is appropriate. Your choice of method will depend on which is best suited for that particular conglomerate. You have the flexibility to determine if one method, or a combination of the methods, most appropriately captures the risk and capital structure of the conglomerate. Examples of each of the methods are contained in Appendix B.

When applying any of these methods, you need to take into account any of the conglomerate's proportional share of any less than wholly owned entities. Proportional share means the proportion of the subscribed capital which is held directly, or indirectly by that entity. When a regulated lower tier entity has a capital deficit, or an unregulated entity has a notional capital deficit, you will need to determine how to best reflect that deficit in your analysis. If a conglomerate holds a majority interest, and in some instances a minority interest, you would typically include the entire capital deficit in your analysis. However, if you determine that the parent holding company is only responsible for its share of that entity's capital deficit, you may account for that capital deficit on a proportional basis.

Regardless of the method chosen, you must ensure that: 1) any capital gearing or intra-group capital is eliminated; 2) that the capital requirements for each different financial sector shall be met by available capital as calculated according to the corresponding rules of that sector; 3) if the parent has a capital deficit only cross-sector capital that complies with the parent's capital rules is allowable; 4) where sectoral rules limit the eligibility of cross-sector capital, these limits would apply in principle when calculating capital at the level of the conglomerate; 5) when calculating available capital at the conglomerate level, you must consider the effectiveness of transferability of capital across different legal entities; and 6) in the case of a nonregulated entity, a notional solvency requirement must be calculated, or the parent's investment in the nonregulated entity (as determined under the equity method of accounting) must be deducted from the group's capital.

If there are capital surpluses within the conglomerate, you will need to determine if those surpluses can be employed in other parts of the organization. For instance, you will need to determine if the capital surplus of an insurance entity or sector can be transferred to the parent or another entity within the group. In making that determination, there may be legal, tax, shareholder rights, policyholder rights, restrictions imposed by primary regulators, and other considerations that will need to be weighed in assessing if the surplus capital is transferable. You will also need to consider the capital rules for the relevant sectors and whether the surplus capital is of a form that would meet the capital eligibility rules of the other sectors. If not, then the surplus capital should not be considered transferable and available to other parts of the conglomerate.

The Accounting Consolidation method compares the fully consolidated capital of the conglomerate to the sum of the capital required for each sector or

entity. Available capital includes only those elements that qualify for regulatory capital in accordance with the relevant rules for each sector. The regulator for each entity or sector determines the regulatory capital required. This method requires the elimination of all intra-group balance sheet transactions, which is usually accomplished by consolidating the entities. The capital surplus or deficit positions for each subsidiary is then identified and used to assess the availability of capital group-wide to resolve any capital deficits. You will also need to develop a notional capital proxy for any unregulated entities, or deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital when a proxy is not available, and then add together the total capital required amounts and compare to the available capital group-wide.

The Deduction and Aggregation method involves summing the available capital of each regulated and nonregulated sector or entity in accordance with the appropriate sectoral rules and comparing this to the sum of the individual capital required of the regulated sectors and the notional capital proxies for the unregulated sectors, plus the book value of the investments in those entities or sectors. The book value of the investments are included as they represent geared capital that is not eliminated because this approach is conducted using the conglomerate's unconsolidated accounts. If you cannot develop a notional capital proxy for an unregulated entity, then you should deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital.

The third method is the Book Value / Required Deduction method. This method takes the balance sheet of each company within the group and looks through to the net assets of each related company using unconsolidated balance sheet data. The conglomerate's capital surplus / deficit is calculated as the difference between parent's available capital and the sum of the parent's required capital and the higher of the book value of the parent's investment in each entity or sector and the capital required for each entity or sector.

When evaluating capital adequacy, regardless of the method, you should consider the following points:

- What is the conglomerate's capital and capital allocation strategy?
- Does the conglomerate have an effective capital adequacy policy? Does it describe their capital and capital allocation strategy? Does it identify minimum capital thresholds?
- Where is capital held within the conglomerate and why is it held there?
- What factors affect the allocation of capital across the conglomerate (for example, regulatory or risk factors)?
- How are decisions made on capital allocation?
- How are capital decisions affected by the legal entity and business line structures?
- Do management and the board periodically review overall capital adequacy as well as the capital adequacy of the individual subsidiaries?
- Are there any plans to issue new capital instruments or additional equity? Are there any stock repurchase plans in place or contemplated?
- To what extent, if any, are legal entities able to raise capital on more favorable terms than others?
- Is the parent and/or any of the individual entities rated by the rating agencies? If so, what are the ratings? Have any of the rating agencies indicated that their ratings are under review for an upgrade or a downgrade? If so, what are the implications for the organization?
- Is there surplus capital available in the corporate structure that can be transferred to other entities within the conglomerate? If so, are there impediments to flows of capital among legal entities?

- What restrictions are placed on the instruments available to the conglomerate for raising capital and what is the nature of the restrictions? Consider the affect of debt covenants.
- Are there unregulated entities within the corporate structure? If so, what are their lines of business? Do any of the regulated entities have significant interests in on- or off-balance-sheet assets or liabilities with these entities, such as debt guarantees?
- Are partial ownership interests present in the structure of any of the subsidiaries? If so, what are their ownership and voting rights? Are there other factors that could influence a determination as to their obligations?
- Have you evaluated quality of capital issues, such as the use of subordinated debt or other equity-like instruments that may not be considered to be acceptable regulatory capital for all of the regulated entities across the conglomerate?
- Have all of the intercompany transactions been identified that could impact your capital assessment? Such intercompany transactions could be on- or off-balance sheet or include less obvious items such as significant tax liabilities.
- Does the conglomerate or any of its individual entities securitize any of its products? If so, how are the securitizations managed and structured? Are the securitizations properly accounted for and monitored on a regular basis? Are these activities properly capitalized?
- Are there significant derivatives outstanding? What is the impact of the derivative positions on capital adequacy?
- If derivatives are present, are they used to hedge certain risks, to speculate on market movements, or are any of the entities actively engaged in derivatives as a line of business?

Prior to undertaking your capital analysis, you will need to understand the conglomerate's organizational structure. Only by understanding the legal structure of each significant entity, can you begin to consider the capital implications.

ORGANIZATIONAL STRUCTURE

As with all holding company enterprises, you must determine the organizational structure and reporting hierarchy. It is not unusual for a conglomerate to have a large number of separately chartered legal entities. Some of the entities within the conglomerate may be regulated, whereas others may not.

In assessing the organizational structure of the conglomerate, you should consider:

- What factors influence the overall approach to the corporate legal structure?
- How closely is the conglomerate's business line structure aligned with its corporate legal structure? If not closely aligned, what factors influenced the "divergent" structure?
- What is the conglomerate's strategy with respect to corporate legal structure?
- Does management feel this is an ideal structure? If not, what changes would make it optimal and what impediments exist that prevent management from implementing those changes?
- What legal entities are regulated, and by whom? How does management view the regulatory structure within which it must operate?

In addition to wholly or majority owned subsidiaries, the conglomerate may have a variety of significant investments where they are not the majority owner. Despite the fact that these investments represent only a minority ownership interest, they may, nonetheless, be important to the ongoing operation and financial condition of the conglomerate. They may also add increased or additional types of risk to the structure. You should also identify minority investments and evaluate their risk.

Understanding the organizational structure, and the factors that influence its design will better position you to evaluate the risks within the conglomerate. By combining business lines, conglomerates offer the potential for broad diversifications. However, new risk concentrations may arise at the group level. More specifically, different entities within the conglomerate could be exposed to the same or similar risk factors, or to apparently unrelated risk factors that may interact under unusually stressful circumstances.

A risk concentration refers to exposures or loss potential that is borne by entities within the conglomerate that are large enough to threaten the capital adequacy, or the financial position in general, of the entities in the conglomerate. Risk concentrations can arise in a conglomerate's assets, liabilities or off-balance sheet items. Risk concentrations can take many forms, including exposures to:

- Individual counterparties;
- Groups of individual counterparties or related entities;
- Counterparties in specific geographical locations;
- Industry sectors;
- Specific products;
- Service providers (for example, back office services); and
- Natural disasters or catastrophes.

Conglomerates must have comprehensive systems to measure, monitor, and manage risk concentrations. Systems should be able to aggregate exposures across legal entities and business lines. To assess whether the conglomerate has adequate risk management processes in place to manage group-wide risk concentrations, you should consider:

- What are the conglomerate's principal risks? For each risk:
  - — How does the conglomerate measure the risk?
  - — What kinds of risk reports are available and how frequently are they produced? Who reviews and is responsible to respond to the reports?
  - — Is the risk managed centrally or by individual legal entities?
- What are the major risk-taking legal entities within the conglomerate?
- What risk control mechanism does the conglomerate have in place (for example, limits, vacation policy, job rotation)? If limits exist, are they established by legal entity, business line, or conglomerate? Who establishes and monitors them? Who has authority to override limits?
  - — Does management perform stress testing, contingency planning and back testing? If so, evaluate the results.

Most conglomerates will have some degree of country risk. Country risk is an exposure, credit, price, capital markets, foreign exchange, settlement, or other type of risk, that can be directly impacted by the social, political, economic, or legal climate of other countries. These risks can arise from direct lending to foreign borrowers, underwriting insurance to foreign entities, entering into capital market contracts with foreign counterparties, or operating offices or subsidiary companies in other countries. These risks are present with both foreign and domestic entities or other entities, and sovereign nations themselves. You will need to determine if the conglomerate has significant direct or indirect country risk. A conglomerate has direct country risk when it is a party to financial transactions with entities based in other countries as compared to indirect foreign risk wherein the conglomerate is a party to financial transactions with entities based in the same country and that entity has direct foreign risk. An example of indirect foreign risk would be an American based conglomerate lending to an American manufacturing company that has foreign operations or other significant foreign exposures. The manufacturing

company could be impacted by adverse results of its international operations caused by political changes that directly affect the company's repayment abilities. If the conglomerate does have significant country risk, you will need to consider:

- If board approved policies, procedures, and authorizations have been established?
- If country limits have been established and if the actual exposures versus the limits are monitored on a regular basis at a senior level?
- If country risk exists to emerging market countries that may be more volatile, or is the country risk limited to developed countries?
- If country risk is monitored and controlled on a centralized or decentralized basis?
- If an effective country risk rating system that risk ranks foreign exposures, including credit and capital market exposures, has been established?

A specific type of country risk is foreign exchange risk, i.e., the conglomerate undertakes transactions in foreign currencies that are subject to price and settlement risk. If the conglomerate is exposed periodically or continuously to significant foreign exchange risk, then you will need to consider:

- How the conglomerate manages its foreign exchange risk?
- What type of foreign exchange risk is the conglomerate exposed to, such as direct lending in other currencies, capital market transactions in other currencies, or overseas operations that are funded in other currencies?
- How large is the conglomerate's foreign exchange risk relative to earnings and capital?
- Do the conglomerate's policies and procedures directly address authorizations for conducting such transactions and exposure limits by types of transactions and by country?
- Does the conglomerate maintain specific foreign exchange counterparty and settlement limits by entity? Are the limits monitored on a regular basis with exceptions identified?
- Does the conglomerate hedge its foreign exchange risk? If so, what policies, procedures, controls, and reporting have been established?

As you draw conclusions about risk concentrations, keep in mind that all risk concentrations are not inherently bad if well managed. A certain degree of concentration is an acceptable result of a well-articulated business strategy – for instance, product specialization or targeting a particular customer base.

RELATIONSHIP

The integrated nature and size of a typical conglomerate makes it a challenge to assess the effectiveness of management and the relationship between the various entities in the group. In our role of supervising the conglomerate, we must look beyond how decision makers, and the relationship in general, impact the thrift to also assess how management oversees the conglomerate as a whole. You should begin by considering:

- What is the overall management structure of the conglomerate?
- How closely does the management structure align with the business lines or corporate legal entities and what is the strategy for alignment?
- How is the conglomerate managed and controlled – on a regional basis, on a global basis, business line basis, or some combination of these?
- How does the conglomerate manage businesses that cut across geographic and legal boundaries?
- What responsibilities do different types of managers (for example, legal entity, corporate, or business line) have within the conglomerate and how do these managers interact?

- What roles and responsibilities does the conglomerate's board of directors have? What is the composition of the board? For example, what percentage is outside directors? Are outside directors independent of management? How do the roles and responsibilities of the conglomerate's board compare to those of the legal entities? What degree of overlap exists?

In its oversight role, the board must ensure that the conglomerate's risk management program is adequate to identify, monitor, and control any significant risk to the conglomerate. Conglomerates with good risk management programs will rely on a reporting and control system that clearly identifies emerging and established risks posed by excessive concentrations, changing markets, economies, and interest rate environments, substantial or inappropriate intra-group transactions, significant off-balance sheet activities, and compliance with the conglomerate's policies and procedures.

Given that a conglomerate is generally going to be a complex organization, it follows that its internal controls should be sophisticated. An integral part of a good risk management program incorporates a system of internal controls that are sufficient to identify areas of weakness, particularly in financial reporting and accounting systems and records, and with regard to regulatory compliance. Good internal controls will ensure that management and financial accounting reports are accurate and properly portray the risk profile of the conglomerate. Conglomerates with strong risk management programs will ensure that internal controls are well integrated throughout the organization, from the board to line employees, through policies and procedures that clearly delineate authorities, responsibilities, permissible activities, and limits. You will need to evaluate how the conglomerate ensures the integrity of its internal control structure, including controls over information technology (IT). You should begin your assessment by asking the following questions:

- Does the conglomerate maintain an effective risk management program? Is the board and senior management actively engaged in risk management? Does the board approve risk management and other significant policies?
- Do policies and procedures clearly delineate limits, activities, responsibilities, and authorities? Are policies and procedures updated on a timely basis for changes? Are policy and procedural changes communicated to employees?
- Are management reports sufficient to identify and monitor significant risks to the conglomerate? Are these reports accurate and timely? Who reviews these reports and how often?
- Does the conglomerate model its significant risks? If so, do they properly document the methodology, data, and assumptions employed? Do they back-test the results? Who reviews modeling results and how often?
- Is the system of internal controls appropriate to the type and level of risks posed by the nature and scope of the conglomerate's activities? Are controls managed centrally, along geographic or business lines?
- Does the board and management support strong internal controls by properly addressing policy exceptions, excessive risks, regulatory compliance, and employee misconduct?
- Are strong internal controls evident in the conglomerate's IT infrastructure? Is the IT infrastructure subject to outside reviews periodically?
- Are there contingency plans in place for major operational concerns such as IT failures, disasters, liquidity needs, etc…? Are the contingency plans tested and up to-date?
- Does the organizational structure establish clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits?
- Does the conglomerate ensure adequate separation of duties where appropriate throughout the organization?

- Are internal controls and information systems adequately tested and reviewed with coverage, procedures, findings, and responses properly documented and material weaknesses reviewed at an appropriate level? Are exceptions corrected effectively and on a timely basis?
- What mechanisms are in place to identify and correct internal control breaches, violations, and other issues of noncompliance?
- What information is available to monitor and ensure compliance with relevant laws and regulations?
- How is the internal audit function structured? What roles and responsibilities belong to the centralized element of the audit function (if there is one)? What roles belong to centralized units of the internal audit function, if any?
- What types of information, summaries and reports are available on the results of internal audits? To whom is this information available? What is the process for following up or acting on issues requiring action identified by the internal auditor?
- How does the conglomerate ensure sufficient independence of the internal audit function? To whom does the internal audit function report? Are there any aspects of the audit function that are outsourced? If yes, to whom and how is the decision to outsource made?
- How does the conglomerate ensure the independence of the external audit process? What is the role of nonexecutive board members? How does the external audit firm interact with the internal audit function? How does the conglomerate select its external auditor?
- What information is available on external audit issues? Who is this information made available to? Who is responsible for, and what follow-up is conducted, with respect to deficiencies or other issues identified by the external audit?
- What are the major incentives provided to management to meet the conglomerate's goals and objectives? What impedes meeting these goals and objectives?
- How are strategic business and individual goals developed, communicated, and monitored?

Intra-group transactions and exposures are an important element of corporate governance and internal control. Given the size, complexity and number of legal entities within a large conglomerate, control over capital, funding, and other risk and income-transferring mechanisms is critical. Furthermore, different approaches to capital regulation and accounting requirements in different financial sectors may increase the opportunities for regulatory arbitrage.

Intra-group transactions and exposures can facilitate synergies between the different legal entities in the conglomerate. Such synergies can lead to healthy cost efficiencies and profit maximization, and more effective control of capital and funding. However, significant intra-group transactions and exposures can also expose one part of a conglomerate to problems or ailments in another part of the conglomerate. Where regulated entities are predominant in the conglomerate, and business lines and other activities follow legal entity lines, there may be few supervisory concerns.

However, if there are significant unregulated entities in the conglomerate, or the way in which the operations are managed differ from the legal entity structure, then sound management of intra-group transactions is even more important.

It is management's, and ultimately the board of directors', responsibility to achieve the appropriate balance between the benefits and risks of intra-group transactions and exposures. Sound risk management of intra-group transactions and exposures begins with policies and procedures approved by the board or other appropriate body and active oversight by both the board and management. The conglomerate's policies and procedures should set transaction and exposure limits.

Intra-group transactions and exposures can take many forms. You are probably most familiar with the transactions that are covered by the affiliate regulations involving a thrift. In a conglomerate, new types of intra-group transactions and exposures arise. Intra-group transactions and exposures can arise through:

- Cross shareholdings;
- Trading operations whereby one company within the group deals with, or on behalf of, another company in the group;
- Centralized management of short-term liquidity within the conglomerate;
- Guarantees, loans and commitments provided to, or received from, other entities in the group;
- Providing management or other service arrangements (for example back office services);
- Exposures to major shareholders (including loans and off-balance sheet exposures such as commitments and guarantees);
- Exposures arising from placing client assets with another legal entity in the group;
- Purchases or sales of assets between entities in the group;
- Transfer of risk through reinsurance; and
- Transactions that shift third party risk exposure between entities within the conglomerate.

Your assessment of intra-group transactions and exposures can begin by considering:

- What information is available on the range of intra-group and related entity transactions and exposures? What types of management information reports are produced and how frequently?
- What is the conglomerate's overall strategy with respect to intra-group transactions and exposures? What types of intra-group/related entity transactions or other arrangements are used (for example, servicing agreements, loans)?
- How are intra-group and related entity exposures and transactions monitored?
- What is the volume of intra-group/related entity transactions and level of finance exposures? Does the conglomerate have internal limits or thresholds on such transactions or exposures? Are there internal or external limits or thresholds on such transactions or exposures (such as regulatory, borrowing, or board set limits)?
- What is the level of financial exposure to entities that are not wholly owned? Are there limits or thresholds for transactions and exposures to such entities?

The following transactions with any regulated entity in the conglomerate would raise supervisory concern:

- Transactions that result in capital or income being inappropriately transferred from a regulated entity.
- Transactions that are on terms or under circumstances that are not at arm's length or not under terms and circumstances that a third-party would accept.
- Transactions that can adversely affect the capital, liquidity or profitability of entities within the group.
- Transactions that are used as a means of supervisory arbitrage to evade capital or other regulatory requirements.

Public disclosure of intra-group transactions and exposures can promote market discipline by providing insight into the relationships among the various entities in the conglomerate. Insightful public disclosure allows for more effective market discipline because stakeholders in the conglomerate will be better able to understand the dynamics of

the conglomerate's financial statements and risk management activities.

Intra-group relationships and transactions, on- and off-balance sheet, will often times significantly impact how a company within the group operates, raises its funding, implements its risk management program, and manages other facets of its business. Understanding these relationships between entities within a conglomerate is an important and necessary initial step to analyzing its capital adequacy and financial performance.

EARNINGS

A conglomerate, by definition, will be a large complex business, likely encompassing a number of different lines of business, with each line of business offering a variety of different products. As a result, your earnings assessment will need to include an analysis of each of these different business segments to understand how they contribute to the financial performance of the conglomerate as a whole. You will, therefore, first need to understand the organizational structure of the conglomerate to determine the primary lines of business, the most significant entities within the group and their roles, as well as their geographic reach. Only after achieving a solid understanding of the organizational structure, and the interrelationships among the entities, can you begin to analyze earnings.

Your assessment will include an analysis of earnings, cash flow, and liquidity, conducted on both a consolidated and an unconsolidated basis. You will have to identify those entities that contribute significant earnings, cash flow, and liquidity to the parent company or affiliates. The analysis of inter-company support via earnings, cash flow, and liquidity is as important as understanding the contribution of the individual entities to the consolidated conglomerate's results. While inter-company transactions can be managed in a prudent manner and to the benefit of the conglomerate, such transactions can also transmit financial problems to other entities within the group and jeopardize the reputation, and possibly, the financial stability of the conglomerate. You need to identify those situations where inter-company transactions pose concerns and potential risk to the conglomerate.

Your analysis may be complicated when any significant entities within the group are unregulated. If a significant company within the group is unregulated, then regulatory reports will not be available to provide insight into the financial performance of that company or line of business. Available information may be limited to only the public domain and what the conglomerate provides. In addition, inter-company transactions between unregulated entities can pose a greater risk, as they are not subject to regulatory restrictions or review. Only by understanding the individual entities, regulated and unregulated, and group-wide earnings and cash flows, can you properly assess the conglomerate's financial stability, ability to service debt and pay dividends, and generate new capital to support growth and losses.

Begin your analysis with a review of the conglomerate's corporate structure and identify the major entities, the predominant lines of business, regulated versus unregulated entities, the primary business products, and their geographic reach. You will need to review the analyses performed as part of the Organization and Relationship sections of this Handbook module. After completing this review, you will need to consider:

- If any regulatory reports describe concerns with the financial or risk profile of a company or line of business, or with any inter-company transactions?
- Are there any inter-company transactions that are indicative of a particular business segment or significant company that is overly reliant on other parts of the conglomerate for financial support? Your review should include analyzing consolidating balance sheets and income statements for on-balance sheet items, and other reports for off-balance sheet inter-company relationships, such as financial derivatives.

- Are there any lines of business or significant entities within the conglomerate that are experiencing earnings, cash flow, or liquidity problems? If so, has management identified the situation and developed a remedial plan?
- How is the financial control function organized with respect to legal entities and business lines? What part of the conglomerate is responsible for accounting and financial reporting issues?
- Does the conglomerate obtain annual independent audits? If so, are audits prepared for the conglomerate on a group-wide basis or are there individual audit reports for separate entities within the corporate structure? Is the audit opinion qualified in any manner? Are there any significant audit adjustments?
- What accounting rules are used by the conglomerate? How are these rules applied across the conglomerate? How do they vary across geographic lines and business segments? How is accounting reconciled across different financial sectors or countries?
- Are there any new accounting pronouncements that will significantly impact any of the individual entities?

The ability of the conglomerate to generate consistently strong earnings provides the ability to grow, pursue opportunities, access capital markets at reduced costs, and absorb losses. The earnings strength of the conglomerate will be dependent on the earnings of the major business segments. Each business segment may have significantly different factors driving its earnings from stock market activity for a securities broker/dealer, to the interest rate and credit risk environment for a bank, to catastrophic weather events for a property and casualty insurance underwriter. As a result, the conglomerate's earnings may have components that are cyclical or volatile in nature, or susceptible to particular events, all of which you will need to consider. In addition, your analysis should focus on the most significant, and if present, the most problematic entities within the conglomerate.

When conducting your analysis, you will need to consider:

- How profitable are the major business segments and the significant entities within the conglomerate? What are the short and long term profitability trends?
- Are earnings stable and generated by core operations, or are there volatile or cyclical earnings components?
- Are significant nonrecurring gains present, such as a large gain from the sale of assets that are benefiting net income?
- Are there unprofitable or under-performing business segments or significant entities within the conglomerate? If so, how is management addressing these problems?
- How strong are the conglomerate's basic financial measures, such as return on equity, cost of equity, return on assets, and turnover?
- Does management and the board periodically review earnings performance of the individual entities and on a group-wide basis?
- Does the conglomerate have a budget and financial projections? Are they produced at the individual company level and on a group-wide basis?
- Are any of the individual entities or lines of businesses significantly under-reserved for potential losses?
- Does the strategic plan identify any major actions such as stock repurchase plans, new products, or lines of business that will have a significant financial or risk impact on any of the entities or lines of business?
- How do the individual entities and the conglomerate as a whole, manage their income taxes? Are there significant income tax liabilities due? Are there any new changes to income tax regulations or laws that will significantly alter future tax liabilities?

Your assessment of the financial stability of the conglomerate will also need to identify potential problems with cash flow or liquidity within the conglomerate. To identify potential cash flow or liquidity issues, you will need to analyze the cash flow and liquidity needs and resources for each major company and/or line of business. In addition, you may need to evaluate the balance sheet of the underlying entities to identify significant concentrations of assets that are not liquid or do not generate cash, such as goodwill or deferred policy acquisition costs.

Of prime concern is the conglomerate's ability to meet its financial obligations on a timely basis. If one company within the group defaults, or loses the confidence of market participants, the reputation and financial wherewithal of the entire organization can be jeopardized, which can translate to problems for an entire sector and other conglomerates if there are significant cross-holdings. Your analysis needs to identify any concerns with a conglomerate being able to meet its financial obligations on a timely basis including repaying debt, honoring financial derivatives, debt guarantees and other types of commitments, and meeting all underlying debt and other types of covenants. You will need to identify concerns with deterioration in a company's debt service abilities and/or liquidity position, and seek remedial action where appropriate. Your analysis will need to consider:

- Is there publicly available information from rating agencies on the conglomerate or its significant subsidiaries? Is the conglomerate well rated and considered financially sound? Has any rating agency announced its intent to conduct a credit review of the conglomerate with an outlook towards changing the rating?
- Do regulatory reports of individual entities or lines of business indicate any concerns with cash flow management, the liquidity position, or the ability of an entity to meet its financial obligations?
- Is access to the capital markets performed only at the parent level or through a specialized entity, or do the individual entities maintain access to the capital markets?
- Are there any legal, tax, or regulatory restrictions that could impact the conglomerate's ability to manage its cash flows and service its debt?
- Are there inter-company guarantees provided on debt or other types of contracts that could pose a significant funding issue?
- Are there other types of inter-company transactions, particularly with unregulated entities within the group that could impact the financial strength of a company within the group?
- How is cash flow and liquidity managed for the conglomerate as a group and on an individual company basis? Are these functions centralized or decentralized?
- Does the conglomerate and the individual entities maintain liquidity and borrowing policies and limits consistent with prudential standards? How are these policies and limits applied group-wide?
- How are liquidity and cash flow demands measured on an everyday basis? Is senior management regularly involved in monitoring the liquidity needs of the conglomerate? What information is available on liquidity? How frequently is it produced?
- Do the individual entities generate sufficient cash flow to service their own debt or are they reliant on subsidiaries or outside resources to meet debt service and other obligations?
- Is there any significant credit drawn or available to any of the entities? If so, are there any significant restrictions or covenants associated with any credit agreements that could prevent the payment of dividends or other transfers of capital, the use of liquidity, ability to borrow, or otherwise significantly impact the conglomerate's or any of the individual company's operations or ability to service it's debt?

- Are there any significant unfunded obligations, such as under-funded pension plans, that could significantly impact the conglomerate's liquidity or earnings?
- Are there significant off-balance sheet items such as commitments, securitizations, financial derivatives, or lease commitments that could require significant liquidity commitments at the conglomerate level or at any of the significant subsidiaries?
- What plans have been made for crisis or contingency funding? To what extent have such plans been elaborated?

As you conduct your financial analysis, refer as needed to Section 600 of this Handbook for additional guidance. You have the flexibility in choosing those areas of the Handbook that will be useful in completing your assessment.

Your conclusions about the financial wherewithal of the conglomerate will need to carefully weigh all of the above factors, as well as consider management's approach in conducting the conglomerate's business and the organizational structure. Your final assessment should be from the perspective of the conglomerate as a whole, highlighting its financial strengths and weaknesses. You should also address any significant concerns with the financial stability of any of the major underlying entities, regulated or unregulated.

SUMMARY

Your assessment of a conglomerate will require you to carefully weigh all of the CORE components and their interrelationships. You will need to conduct your comprehensive assessment from the perspective of the consolidated regulator at the parent, top-tier, organization within the conglomerate. Particular emphasis, however, should be placed upon a parallel assessment of the top-tier financial company. While the primary emphasis will be to analyze the conglomerate's capital adequacy and risk profile, such an analysis cannot be conducted without first considering the Organization and Relationship components. In order to understand the dynamics of the conglomerate, you will need to:

- Understand the organization – how it is structured, managed, and controlled. You will need to identify the conglomerate's most significant entities and understand how they conduct their business.
- Identify and understand all significant intra-group relationships and transactions to assess their impact on the organization's earnings, risk profile, and capital adequacy.
- Coordinate closely with other regulators and consider their examination and inspection reports, publicly available information, and information provided by management.
- Assess the conglomerate's major risk exposures and how these risks are impacted, both domestically and internationally, by economic changes, legal and tax considerations, how the conglomerate conducts its business, and the stability of the financial markets in which they operate.
- Determine the conglomerate's group-wide capital adequacy. This includes assessing capital adequacy relative to the needs of each major business sector and the parent's own capital adequacy.

As the consolidated regulator of the conglomerate, we need to ensure that we coordinate closely with all interested regulators worldwide. This involves sharing information with other regulators so that all parties understand the conglomerate's overall dynamics. This also involves being prepared to act accordingly in the event of a crisis by obtaining information from the conglomerate on the consequences of such an event, their contingency plans and options to minimize the impact of a crisis, and exchanging information with all interested regulators to assist in coordinating and executing any necessary supervisory actions.

Appendix A: Financial Activities in the European Union

Section 940A

Worldwide, the regulation of conglomerates is evolving. Banking, insurance, and securities regulators have recognized that the risks of the combined enterprise must be evaluated. The Joint Forum[1], a group established by the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors, has outlined principles related to the supervision of conglomerates.

It is widely recognized that a form of supplementary supervision is needed and that a central regulatory contact point is essential. As the word "supplementary" implies, the supervision of the enterprise is in addition to the role of the primary regulator(s) for each financial sector. Since the OTS has numerous holding companies with operations throughout the world, this guidance is designed to ensure that our regulatory approach to conglomerates is considered equivalent to the standards and principles set by other governing bodies. This approach ensures that our holding companies are on a level playing field, and not subject to unnecessary or duplicative regulatory burden by having to comply with differing regulatory schemes.

The substance of the guidance provided throughout this Section relies heavily on documents produced by the Joint Forum. In particular, in July 2001, the Joint Forum produced a compendium of documents on issues relating to conglomerates.[2] These papers document the combined thoughts of representatives of various and different financial sectors across many nations with regard to what supervisory measures are needed to adequately oversee a conglomerate. The compendium of documents address coordination among regulators, information sharing, capital adequacy, fit and proper tests on management's capabilities and effectiveness, intra-group transactions and exposures, and risk concentrations.

The European Parliament and the Council of the European Union issued a directive on December 16, 2002 (EU Directive) outlining measures to address the risks with regard to financial groups with financial activities across more than one sector.[3] The articles of the EU Directive and objectives therein outline a supervisory approach similar to that spelled out in the Joint Forum documents. U.S. companies engaged in financial activities in a member state of the European Union[4] may fall within the scope of the EU Directive.

The EU Directive defines a conglomerate as a group of companies under common control that engage predominantly in financial activities (insurance, securities, and banking). Conglomerates must have a significant interest in insurance and at least one other financial activity (banking or securities), to fall within the scope of the EU Directive. In addition, the ratio of aggregate assets of all financial sector entities to total consolidated assets of the conglomerate should exceed 40 percent.

An interest in a financial sector is considered significant if:

- The ratio of that sector's assets to the total financial sector assets exceeds 10 percent; and
- The ratio of the capital requirements imposed by the regulator of that sector to the total aggregate capital requirements for all financial sectors in the group exceeds 10 percent.

[1] The Joint Forum is comprised of an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency. Thirteen countries are represented in the Joint Forum: Australia, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, United Kingdom and the U.S.

[2] http://www.bis.org/publ/joint02.pdf

[3] http://europa.eu.int/eurlex/pri/en/oj/dat/2003/l_035/l_03520030211en00010027.pdf

[4] As of November 2003, the member states include Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden, and the United Kingdom. The following countries are in process of fulfilling the requirements to accede to the European Union: Estonia, Latvia, Lithuania, Poland, Hungary, Slovakia, the Czech republic, Slovenia, Malta, and Cyprus.

The EU Directive also recognizes that it may be appropriate to apply this guidance in situations where these thresholds are not met or maintained. For instance, if one or more of the ratios noted herein fell below threshold levels during the current annual cycle, but is expected to return to prior levels. Similarly, there may be situations where these thresholds are never met, but the characteristics of the conglomerate warrant reviewing it as if it were.

The EU Directive requires that one single authority be appointed for the overview of each conglomerate and that such authority ensure that information is coordinated and exchanged between the different supervisors involved in the supervision of the conglomerate's component parts.

The regulator that will perform the supplemental supervision is typically identified through mutual agreement among all concerned member states, however, where an agreement is not reached, authority is assigned to the regulator of the parent regulated entity. If the parent is not a regulated entity, certain geographic and quantitative tests are employed to assign the role to the member state with the most significant connection to the group. Regulators in third-party countries (countries like the U.S. that are not members to the European Union) can serve in this role if their supervisory approach is deemed to be equivalent to the supplementary supervision regime. While an equivalency determination will ultimately be made by the regulatory authorities of the member states, OTS believes that its supervisory approach is equivalent. Section 940 is designed to ensure that the scope of our holding company examination of a conglomerate is sufficient to fulfill these responsibilities under the EU Directive.

If OTS is deemed equivalent, you must ensure that our responsibilities in this role are fulfilled. Our responsibilities would include gathering and disseminating relevant or essential information. We would also need to ensure that there are procedures for sharing information on an ordinary basis as well as in emergency situations. Close coordination with fellow regulators is achieved through periodic meetings, input on the content of the enterprise's supervisory plan, and sharing of information obtained in regulatory reports filed by each agency. Information sharing or regulatory cooperation agreements may be in place, but are not required by the EU Directive.

If a holding company enterprise is subject to the EU Directive, a primary staff contact will be designated to communicate with international regulatory authorities to initiate information sharing procedures and develop an appropriate Supervisory Plan for the conglomerate.

The prescribed methods to assess group-wide capital include the Accounting Consolidation method, the Deduction and Aggregation method, and the Book Value / Requirement Deduction method. In addition, if necessary, you can also combine two or more of these methods to conduct your capital adequacy analysis. The following pages outline the three methods and provide examples of each.

The following is an abbreviated consolidated balance sheet divided into the individual subsidiaries including a banking company that is the parent, an insurance subsidiary that is wholly owned by the parent, a securities company that is 60 percent owned by the parent, and an unregulated finance subsidiary that is wholly owned by the parent. The examples in this appendix are based on the financial information shown below.

	Regulated Banking Parent	Regulated Insurance Subsidiary 100% Owned	Regulated Securities Subsidiary 60% Owned	Unregulated Finance Subsidiary 100% Owned	Eliminations	Consolidated
Most Assets	$315	$150	$225	$120		$810
General Reserves	-4	-2	-2	-2		-10
Investment In:						
Insurance Sub.	10					
Securities Sub.	12					
Finance Sub.	5					
Totals	27	0	0	0	-$27	0
Total Assets	338	148	223	118		800
Total Liabilities	275	138	203	113		729
Minority Interest[1]					8	8
Equity Capital	63	10	20	5	-35	63
Liabilities & Equity Capital	$338	$148	$223	$118		$800

[1] In this example, it is assumed that a third party minority investor owns 40 percent of the securities subsidiary. This minority ownership interest equals $20 of equity capital at the securities subsidiary multiplied by 40 percent, or $8.

Accounting Consolidation Method:

- Uses consolidated financial information to eliminate intra-group transactions and capital gearing.
- Breaks down the consolidated balance sheet into its major sectors.
- Compares the conglomerate's consolidated available capital to capital needs.
- Calculates the capital requirement for each regulated entity and a notional capital proxy for each unregulated entity. If a proxy cannot be developed for an unregulated entity, then you should deduct the parent's investment in that entity (as determined under the equity method of accounting) from the group's capital.
- Determines the transferability of capital.
- Aggregates the individual capital requirements and notional capital proxies (or deduction for unregulated entities for which no proxy can be developed) of each entity or sector and compares this to the group-wide available capital to identify a group-wide capital surplus or deficit.

The group-wide capital surplus equals $12 in the second table on the following page. However, this assumes that the capital surpluses of the other entities are available (transferable) to offset the capital deficit at the finance subsidiary. In such an instance, you will need to determine if the surplus capital is transferable to capital deficient sectors and is also eligible as capital in the capital deficient sectors. If the surplus capital is not transferable or eligible, then capital is considered inadequate at the finance subsidiary.

When minority interests are present, you will need to decide whether to include or exclude the minority interests in your capital assessment. The first table on the following page "Accounting Consolidation Capital Assessment Using Full Consolidation" includes the minority interest as available capital while the second table excludes the minority interests from capital. As a result, the $5 capital surplus of the securities subsidiary is pro rated 60 percent, or $3, reducing group-wide capital by $2. See Appendix C for additional discussion of majority and minority interests. Generally, you are expected to exclude or pro rate capital surpluses when the conglomerate holds less than a 100 percent ownership interest in an entity.

However, you are expected to include, and <u>not pro rate capital deficits</u>, when the conglomerate has less than 100 percent ownership in an entity. For example, if the parent's ownership interest in the finance subsidiary were only a majority interest, you would still include the entire $3 capital deficit in your analysis.

Accounting Consolidation Capital Assessment Using Pro Rata Consolidation					
	Regulated Banking Parent	**Regulated Insurance Subsidiary 100% Owned**	**Regulated Securities Subsidiary 60% Owned**	**Unregulated Finance Subsidiary 100% Owned**	**Group-Wide Totals**
Equity Capital	$63	$10	$12.0	$5	**$90.0**
General Reserves	4	2	1.2	2	**9.2**
Available Capital[2]	67	12	13.2	7	**99.2**
Deduct Investment In Subsidiaries	-27	0	0	0	**-27**
Capital Required / Proxy [3]	-32	-10	-10.2	-10	**-62.2**
Capital Surplus / - Deficit	$8	$2	$3.0	-$3	**$10.0[4]**

Accounting Consolidation Capital Assessment Using Full Consolidation					
	Regulated Banking Parent	**Regulated Insurance Subsidiary 100% Owned**	**Regulated Securities Subsidiary 60% Owned**	**Unregulated Finance Subsidiary 100% Owned**	**Group-Wide Totals**
Equity Capital	$63	$10	$20	$5	**$98**
General Reserves	4	2	2	2	**10**
Available Capital	67	12	22	7	**108**
Deduct Investment In Subsidiaries	-27	0	0	0	**-27**
Capital Required / Proxy [3]	-32	-10	-17	-10	**-69**
Capital Surplus / - Deficit	$8	$2	$5	-$3	**$12**

[2] Note that the capital amounts include general reserves as part of available capital. The use of general reserves, or other items, as available capital will vary in different sectors or industries.

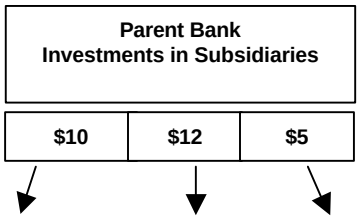
[3] In this example we have developed a notional capital proxy for the unregulated finance subsidiary. If it is not possible to develop a proxy for an unregulated entity, you will need to deduct that entity from the conglomerate's group wide totals. In this example you would need to deduct the unregulated finance subsidiary's $7 of available capital and the $10 capital proxy from the group totals. You would not need to change the $27 deduction for investment in subsidiaries because you would still want to eliminate the parent's $5 investment in the finance subsidiary. Once you have deducted the unregulated entity, you would assess the remainder of the conglomerate's balance sheet as described in this Section of the Handbook. You will need to rely on other tools to assess the capital adequacy of the unregulated entity such as peer comparisons, debt to equity ratios, and cashflow analyses as described in Section 300 of the Handbook.

[4] The table above, "Accounting Consolidation Capital Assessment Using Full Consolidation" includes the minority interest as available capital while the first table "Accounting Consolidation Capital Assessment Using Pro Rata Consolidation" excludes the minority interests from capital. As a result, in the first table the $5 capital surplus of the securities subsidiary is pro rated 60 percent, or $3, reducing group-wide capital by $2, which is the difference in the group-wide capital results of $10 versus $12. See Appendix C for additional discussion of majority and minority interests.

Deduction and Aggregation Method:

- Uses unconsolidated statements and is predicated on pro rata inclusion of subsidiaries.
- Sums the available capital for each regulated and nonregulated entity or sector.
- Sums the capital requirements for each regulated and nonregulated entity or sector with the book value of the investments in the entities or sectors in the group.
- Determines the transferability of surplus capital.
- Compares required capital to available capital to identify a surplus or deficit on a group-wide basis.

The group-wide capital surplus equals $10 in this example. However, this assumes that the capital surpluses of the other entities are available to offset the capital deficit at the unregulated finance subsidiary. In such an instance, you will need to determine if the surplus capital is transferable to capital deficient sectors and if the company is regulated, the surplus capital is also eligible as capital in the capital deficient sectors. If the surplus capital is not transferable, then capital is considered inadequate at the finance subsidiary. Generally, you are expected to exclude or pro rate available capital and required capital when the conglomerate holds less than a 100 percent ownership interest in an entity. However, you are expected to include and not pro rate capital deficits when the conglomerate has a majority interest in an entity. For example, if the parent's ownership interest in the finance subsidiary were less than 100 percent, you would still include the entire $3 capital deficit in your analysis. See Appendix C for additional discussion of majority and minority interests.



	Regulated Banking Parent	Regulated Insurance Subsidiary 100% Owned	Pro Rated Regulated Securities Subsidiary 60% Owned	Unregulated Finance Subsidiary 100% Owned	Group-Wide Totals
Available Capital [5]	$67	$12	$13.2	$7	**$99.2**
Capital Required / Proxy [6]	-32	-10	-10.2	-10	**-62.2**
Inv. in Subsidiaries	-27				**-27.0**
Capital Surplus / - Deficit	$8	$2	$3.0	-$3	**$10.0**

[5] Note that the capital amounts below include general reserves as part of available capital. The use of general reserves, or other items, as available capital will vary in different sectors and countries.

[6] In this example we have developed a notional capital proxy for the unregulated finance subsidiary. If it is not possible to develop a proxy for an unregulated entity, you will need to deduct that entity from the conglomerate's group wide totals. In this example you would need to deduct the unregulated finance subsidiary's $7 of available capital and the $10 capital proxy from the group totals. You would not need to change the $27 deduction for investment in subsidiaries because you would still want to eliminate the parent's $5 investment in the finance subsidiary. Once you have deducted the unregulated entity, you would assess the remainder of the conglomerate's balance sheet as described in this Section of the Handbook. You will need to rely on other tools to assess the capital adequacy of the unregulated entity such as peer comparisons, debt to equity ratios, and cashflow analyses as described in Section 300 of the Handbook.

Book Value / Requirement Deduction Method:

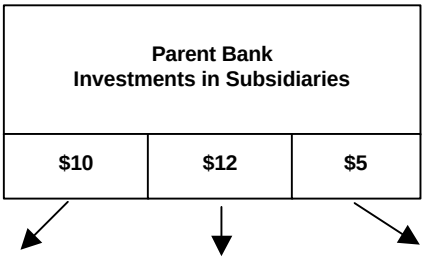
- Uses unconsolidated statements.
- Performs analysis from parent company perspective.
- Predicated on pro rata consolidation of subsidiaries.
- Focuses on capital surplus or deficit of each dependent (subsidiary) and the transferability of available capital to the parent or elsewhere in the group.

Summary Steps to Complete the Book Value / Requirement Deduction Method:

- Calculate the parent's available capital according to the relevant capital rules for that sector.
- Calculate the parent's required capital according to the relevant capital rules for that sector.
- Calculate the higher of the book value of the parent's investment in other entities or sectors, or these entities' capital requirements, pro rated as appropriate.
- Sum the parent's required capital and the higher of the book value of the parent's investment in other entities or sectors and these entities' capital requirements.
- Determine the transferability of surplus capital.
- Calculate the group-wide capital surplus / deficit by comparing the parent's available capital to the sum of the parent's required capital and the higher of the book value of the parent's investment in other entities or sectors, or these entities' capital requirements.

The group-wide capital surplus equals $3 in this example. While this method excludes the available capital of the subsidiaries, it also only takes into account the higher of the subsidiary capital requirements or the investment in the subsidiary, ignoring the lower of the two items. The net result in this case is that surplus capital is estimated to be $3 versus $10 in the prior two methods. While the example calculates a capital surplus, it assumes that the capital surpluses of the other entities are available to offset the capital deficit at the unregulated finance subsidiary. In such an instance, you will need to determine if the surplus capital is transferable to capital deficient sectors and if the company is regulated, the surplus capital is also eligible as capital in the capital deficient sectors. If the surplus capital is not transferable, then capital is considered inadequate at the finance subsidiary. Generally, you are expected to exclude or pro rate required capital when the conglomerate owns less than 100 percent of an entity. However, you are expected to include and <u>not pro rate capital deficits</u> when the conglomerate has a majority interest in an entity. For example, if the parent's ownership interest in the finance subsidiary were less than 100 percent, you would still include the entire $3 capital deficit in your analysis. See Appendix C for additional discussion of majority and minority interests.

Book Value / Requirement Deduction Method (Continued):



	Unconsolidated Regulated Banking Parent	Regulated Insurance Subsidiary 100% Owned	Regulated Securities Subsidiary 60% Owned	Unregulated Finance Subsidiary 100% Owned
Available Capital [7]	$67	$12	$13.2	$7
Capital Required / Proxy [8]	32	10	10.2	10
Surplus/ (Deficit)	$35	$2	$3.0	-$3

Parent's Available Capital ($63 Equity Capital plus $4 General Reserves)		$67
Sum:		
Parent's Capital Required	$32	
Calculate the higher of the book value of the parent's investment in each individual entity or sector or these entities' capital requirements:		
Insurance Subsidiary	10	
Securities Subsidiary	12	
Unregulated Finance Subsidiary	10	
Total Capital Required		64
Group-Wide Capital Surplus / - Deficit		**$3**

[7] Note that the capital amounts below include general reserves as part of available capital. The use of general reserves, or other items, as available capital will vary in different sectors and countries.

[8] In this example we have developed a notional capital proxy for the unregulated finance subsidiary. If it is not possible to develop a proxy for an unregulated entity, you will need to deduct that entity from the conglomerate. In this example you would need to eliminate the $10 deduction for the capital proxy and instead subtract the Parent's $5 investment in the Finance Subsidiary from the $64 of Total Capital Required. Once you have deducted the unregulated entity, you would assess the remainder of the conglomerate's balance sheet as described in this section of the Handbook. You will need to rely on other tools to assess the capital adequacy of the unregulated entity such as peer comparisons, debt to equity ratios, and cashflow analyses as described in Section 300 of the Handbook.

Appendix C: Prudential Treatment of Minority and Majority Interests in Subsidiaries

Section 940C

In reviewing financial conglomerates, you are likely to encounter a variety of different types of control structures ranging from wholly owned subsidiaries to ownership and/or voting interests that may be insignificant. These situations sometimes present difficulties in assessing capital adequacy. In those instances where a lower tier company maintains surplus capital and the conglomerate's investment is less than 100 percent, you will need to decide what portion of the lower tier company's surplus capital is available to the parent. In addition, when a lower tier company has insufficient available capital, the liability to fund the capital deficit may exceed the conglomerate's pro rata interest in that particular company and the entire deficiency should be reflected in your assessment of the conglomerate's capital adequacy.

When you conduct a capital adequacy assessment of a financial conglomerate where minority interests are present, you will need to decide how to apportion any surplus capital, or a capital deficiency, on a group-wide basis. The following example demonstrates: 1) the impact that minority interests and double gearing can have on your capital adequacy assessment, and 2) that full consolidation can produce a more liberal result than the pro rata method.

In this example, a regulated parent holding company has $2,000 of equity capital and invests $300 for a 60 percent ownership in a regulated bank. There is a $200 minority interest in the bank held by a separate third party. The bank has total capital of $500 as shown in the next table. The parent and the bank have required capital levels of $1,700 and $250, respectively. Both entities easily exceed their required capital levels by $300 for the parent and $250 for the bank subsidiary on a stand-alone, unconsolidated basis. The combined, but unconsolidated group-wide capital surplus is $550, as shown in the second table.

	Parent Holding Company	60 % Owned Bank	Elimina-tions	Consoli-dated
Assets:				
Most Assets	$1,850	$900		$2,750
Inv. in Bank	300		-$300	0
Totals	$2,150	$900		$2,750
Liabilities	$ 150	$400		$ 550
Minority Interest			200	200
Equity Capital	2,000	500	-500	2,000
Liabilities & Equity Capital	$2,150	$900		$2,750

However, we need to eliminate the double gearing of downstreamed capital, the parent's $300 equity investment in the bank, through consolidation. As a result, the parent's $300 investment is eliminated and the consolidated surplus capital position declines from $550 to $250 and the parent's available capital now equals its required capital level.

Capital Adequacy Analysis			
	Parent Holding Company	**60 % Owned Bank**	**Group-Wide Totals**
Available Capital	$2,000	$500	**$2,500**
Capital required	-1,700	-250	**-1,950**
Capital Surplus / - Deficit Before Adj. for Gearing	300	250	**550**
Adj. For Gearing	-300	0	**-300**
Capital Surplus / - Deficit After Adj. for Gearing	$0	$250	**250**
Adjustments for Minority Interest			**-100**
Capital Surplus / - Deficit After Adj. for Gearing & Minority Interest			**$150**

You will need to assess the $200 minority ownership interest for any legal and tax restrictions, consider, for example, shareholder rights and regulatory restrictions and decide if all of the $250 surplus capital at the bank is available on a group-wide basis. If you decide that the minority owner's interest in the surplus capital precludes using the surplus capital in your capital adequacy analysis group-wide, you should adjust your analysis accordingly. Generally you should pro rate the surplus capital to recognize that the parent is only entitled to 60 percent of the surplus capital position should the bank decide to pay out the surplus capital. In this example, assume that the minority interest is not available as capital outside of the bank because it is not transferrable to the parent. As a result, $100 ($250 capital surplus multiplied by the minority ownership interest of 40 percent = $100) is deducted from the combined results and the group-wide capital surplus is reduced from $250 to $150. The preceeding example demonstrates how double gearing and the presence of a minority interest can significantly overstate capital adequacy group-wide.

The following example demonstrates the practical implications of assessing capital adequacy when the parent only has a minority interest in a lower tier company and that company has a capital deficiency. Generally you will include the entire capital deficiency of a subsidiary if the conglomerate maintains a majority interest, you also need to consider minority interests between 20 and 50 percent if there are factors present that would create a controlling interest. In this example, it is assumed that although the ownership interest is 40 percent, the conglomerate holds the majority of the board seats which would give it effective control of the insurance company. In this instance, a parent holding company holds a $150 investment in a 40 percent owned insurance company that is accounted for using the equity method.[1] Since the parent's ownership interest is less than 50 percent, the equity method of accounting is applicable. The insurance company has a total capital base of $375 comprised of the 60 percent third-party majority interest of $225 and the holding company's $150 minority investment.

Assume that the parent and the insurance company have required capital levels of $1,700 and $450, respectively. The parent has a capital surplus of $300 on a stand-alone basis and the insurance company has a $75 capital deficit on a stand-alone basis. On a combined basis, the group-wide capital surplus is $225.

	Parent Holding Company	40 % Owned Insurance Company
Assets:		
Most Assets	$2,000	$550
Investment in Insurance Co.	150	0
Totals	$2,150	$550
Liabilities	$150	$175
Equity Capital	2,000	375
Total Liabilities & Equity Capital	$2,150	$550

However, the parent's $150 equity investment in the insurance company represents capital that is double geared and therefore needs to be deducted to properly assess capital adequacy on a group-wide basis. This deduction reduces the group-wide capital surplus from $225 to $75.

Capital Adequacy Analysis			
	Parent Holding Company	**40 % Owned Insurance Company**	**Group-Wide**
Available Capital	$2,000	$375	**$2,375**
Capital Required	1,700	450	**2,150**
Capital Surplus / - Deficit Before Adjustment For Gearing	300	-75	**225**
Deduct Double Gearing	-150		**-150**
Capital Surplus / - Deficit After Adj. For Gearing	$150	-$75	**$75**

[1] While the equity method of accounting is appropriate for minority interests, if you decide that the conglomerate actually maintains a controlling interest in the entity because of other factors, then GAAP may require full consolidation of the entity.

The $75 capital deficit at the insurance company is attributed to the parent in its entirety until the capital deficit is resolved and is not pro rated for the parent's 40 percent minority interest. The entire deficit is assessed against the parent holding company in the event that the majority owner cannot, or will not provide the needed capital. By ignoring this possibility, you may be overstating the capital adequacy of the group. As a result, the capital deficit is not pro rated for the split ownership interest in the insurance company.

Fully aggregating non wholly owned entities with capital surpluses, or not including the entire capital deficit where the parent's interest is less than 100 percent may overstate capital adequacy, if the above assessment is not conducted. In situations where group-wide capital appears satisfactory, but an individual entity has a capital deficit, you will then need to determine if surplus capital from other entities can be transferred to the entity with the capital deficit, and if any additional capital support is available from the third-party majority or minority interests. Note that an actual transfer of capital may not need to be made. You are assessing whether a transfer could be made, if necessary. In doing so, you need to determine if there are any restrictions on the transferability of the surplus capital.

In general, the following guidelines will apply:

- If the group does not maintain control of a subsidiary, normally less than a 20 percent interest, and does not maintain any significant influence through board membership or other avenues, then the parent's investment should be treated in accordance with the applicable regulatory capital rules for that entity. In those instances where capital rules are silent or the subsidiary is unregulated, generally accepted accounting principles (GAAP) should prevail.
- If the ownership interest in a subsidiary gives the group shared control, only the pro rata share of surplus capital should be considered as available to the parent. Typically, pro rata treatment will be applied to ownership interests between 20 and 50 percent. However, careful assessment of the ownership structure is required. In cases where shared control is less than 50 percent, in particular if voting control is under 20 percent or the parent does not exercise any significant control or influence over the subsidiary, the parent's investment should be treated in accordance with the applicable regulatory capital rules for that entity. In those instances where regulatory rules are silent or the subsidiary is unregulated, GAAP should prevail.

When a parent company owns between 20 and 50 percent of a subordinate organization's outstanding voting common stock, the parent should generally reflect the investment on its books under the equity method. The parent initially records its investment in the entity at cost. The parent makes subsequent adjustments to the carrying value to reflect its share of the subordinate's earnings or losses in the period that the subordinate reports its operating results. Also, the parent adjusts its investment to reflect dividends received from a subordinate organization. Under the equity method, the parent does not report a subordinate organization's dividends as income, but rather as cash dividends that reduce the subordinate's net assets and stockholders' equity. Accordingly, the parent should record a proportionate decrease in its investment account for dividends received from the subordinate organization.

The equity method may require other adjustments to the investment account similar to those made in preparing consolidated statements. These include eliminating intercompany gains and losses and to account for any differences between the parent and the subordinate organization in the measurement of the subordinate's expenses. You can refer to APB No. 18, The Equity Method of Accounting for Investments in Common Stock for further details.

- For interests in excess of 50 percent, interests that confer effective control are usually consolidated in full and minority interests are shown separately in the financial statements. Surplus capital can be counted as available to support the risks in the parent company, if ap-

propriate. However, your assessment will need to take into account any types of restrictions on the transferability of the surplus capital in the lower tier entities. There may be legal, tax, shareholder rights, policyholder rights, restrictions imposed by functional regulators, and other considerations that will need to be weighed in assessing if the surplus capital is transferable. If you decide that restrictions are present that prohibit the transfer of all of the surplus capital, then you will need to pro rate the surplus capital to properly reflect the amount available to the group in your capital adequacy analysis.

When a company owns more than 50 percent of a subordinate organization's outstanding common stock, GAAP generally requires the parent to consolidate the subordinate's assets on its financial reports. In a consolidation, the parent's financial reports reflect the financial position, operating results, and cash flows of both the parent and subordinate as if they were a single business entity. The reconciliation process involves the elimination of intercompany accounts and transactions, such as loans and payments between the two entities. Typical intercompany elimination entries pertain to intercompany stock ownership, intercompany debt, and intercompany revenue and expenses. This includes open account balances, security holdings, sales and purchases, interest, dividends, gain or loss on transactions among entities in the consolidated group, and intercompany profit or loss on assets remaining within the group.

When a subordinate organization is majority (but not wholly) owned by a parent company, the subordinate separately reports the minority interest of shareholders owning less than 50 percent of outstanding voting common stock. The minority shareholders have an interest in the subordinate's net assets and in profits and losses.

You should consult Accounting Principles Board Opinion (APB) No. 16, Business Combinations, when there are complex consolidation matters, such as intercompany profits in assets, goodwill, and income taxes on undistributed earnings.