

INTRODUCTION

Section 10(I) 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 PHILOSOPHY IN REGULATING 10(I) 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 super-

vis 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(I) 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 standard-

ized 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(I) 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(I) status.

Some holding companies may elect 10(I) 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(I) 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(I)'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(I)'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.