Introduction

Holding company[1] regulation is a significant element of OTS's supervisory program. Savings and loan holding company enterprises[2] are diverse, ranging from noncomplex companies with limited activities to complex, multinational corporations. Types of companies that own thrifts include:

- Securities brokers or dealers
- Insurance underwriters and agents
- Manufacturing firms
- Retail companies
- Financial conglomerates

Thrift ownership by commercial firms,[3] insurance companies, or financial conglomerates was minimal prior to the 1990's. Those that owned thrifts often operated them independently from the other parts of the organization. Many used the thrift investment to diversify their operations, but did not consider it a critical business component. During the mid 1990s, however, many financial firms, especially insurance companies and securities firms, began offering customers an array of proprietary financial products – insurance policies, savings accounts, mortgage loans, credit cards, and trust services – within the same corporate structure. As a result, ownership and reliance on the thrift charter to provide these services expanded substantially.

This Handbook outlines OTS's risk-focused approach to holding company supervision. It provides guidance to assess the risks of the holding company enterprise. It considers the combined risk profile, financial health, and stability of the enterprise, as well as the interdependence of entities within the structure. The approach is flexible and applies to all holding company structures. You should apply these concepts and standards in each holding company examination; however, you should ensure that you tailor your examination to the complexity and risk level of the holding company. This approach allows you to recognize the unique issues presented by any holding company enterprise.

[1] In this Handbook, the term "holding company" is synonymous with "savings and loan holding company." Similarly, the term "thrift" is synonymous with "savings association."

[2] The term "enterprise" refers to the entire holding company corporate structure or family, including all subsidiaries and affiliates.

[3] The passage of the Gramm-Leach-Bliley Act in 1999 restricted commercial firms from owning thrifts; however, the law grandfathered existing organizations. For more details on the different types of holding companies and activities restrictions, refer to Organizational Structure Section 400.

SUPERVISORY STRATEGY

The Application Process

Prior to organizing or acquiring a thrift, the holding company must file an application with OTS. During the application review, OTS scrutinizes the company's proposed business plan for the insured thrift. The agency analyzes the capital structure, managerial expertise, and overall integrity of the company. The objective is to ensure that the applicant has the financial and managerial resources to operate the thrift in a safe and sound manner without jeopardizing the deposit insurance fund.[4]

During the application, OTS identifies concerns or weaknesses with the proposed structure. Common issues that OTS reviews include:

- Separation of corporate identity – If OTS determines the thrift does not have a separate corporate identity or may have difficulty operating as a stand-alone entity, the agency may require the thrift to hire qualified individuals in key positions. OTS may also require the thrift to perform core business functions independently. There must be a balance between leveraging the synergies of the enterprise and maintaining sufficient independence.

- Third party reliance – If the applicant plans to rely on a network of agents or brokers for referral business, OTS ensures that proper controls are in place and that these representatives will receive comprehensive training.

- Conflicts of interest – If there is a risk that key decision makers working at both the thrift and the holding company could encounter conflicts of interest, the agency may require the thrift to appoint independent directors.

- Liquidity – If the thrift is heavily reliant on affiliates for funding, OTS may require the holding company to establish a segregated, earmarked deposit with the thrift, or that the thrift diversify its funding sources.

- Risk level – If the proposal involves an elevated degree of risk, such as subprime lending, OTS may require the thrift to diversify operations or to hold more capital than the minimum regulatory requirement.

Categorizing Holding Company Enterprises

When OTS approves the application and the holding company forms or acquires the thrift, the resulting holding company enterprise is subject to OTS's supervision and examination. OTS assigns the holding company enterprise to one of the following three categories:

[4] 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.

CATEGORY I	Noncomplex and low risk holding company enterprises.
CATEGORY II	Complex or higher risk holding company enterprises.
CATEGORY III	Conglomerates

Categorizing the holding company population results in more efficient allocation of examination resources and it facilitates examination scheduling and planning. In most cases, Category II holding company enterprises will require more resources than Category I holding companies. OTS defines Category III or "Conglomerates" as corporate enterprises comprising multiple companies or legal entities that operate in different fields. OTS has developed a continuous supervision program for Conglomerates and certain higher risk holding company enterprises. The approach tailors the examination and supervision to address the complex and unique characteristics of this type of enterprise. Section 940 of the Holding Companies Handbook outlines specific examination procedures for Conglomerates.

OTS determines the complexity and level of risk by considering:

- The level of interdependence among the corporate entities in the enterprise, including the thrift's dependence on the holding company and other affiliates to perform core functions;
- Reliance on intercompany borrowings and the method by which the thrift or significant affiliates are funded;
- Type and character of intercompany transactions;
- The risk profile and risk concentrations of the enterprise, including a review of the nature and type of business activities in which the entities in the enterprise engage;
- Financial strength and stability of the holding company enterprise;
- Review of functional supervisors' findings at regulated entities in the holding company enterprise; and
- Review of foreign supervisors' findings at foreign regulated entities in the holding company enterprise.

Holding Companies Handbook Section 710, Holding Company Administrative Program, contains a detailed checklist to determine the appropriate category for a holding company enterprise. The checklist is useful at the conclusion of the application analysis as well as in preexamination analysis. Handbook Section 200, Administration, explains how examiners should use the checklist to assess the enterprise. The category designation directs you to the appropriate holding company examination program.

The Off-site Monitoring Process

OTS conducts off-site holding company enterprise monitoring including reviews of reports filed by holding companies. The off-site monitoring occurs between examinations for noncomplex and low- to moderate-risk holding companies. For certain high-risk, complex, and conglomerate holding companies, OTS conducts continuous supervision and examination.

Holding companies file quarterly H-(b)11 reports. The H-(b)11 reports require the holding company to submit SEC filings, audited annual financial statements, quarterly financial statements, descriptions of material events, and documentation related to the holding company's charter, bylaws, or material agreements. The subsidiary thrift also files quarterly electronic holding company financial data as part of its Thrift Financial Report[5]. For most holding company enterprises, OTS designates one holding company for which the thrift must provide financial information. In some cases, where more than one distinct ownership path exists, or other supervisory needs exist, there may be more than one designated filer.

OTS uses private sector information to supplement its analysis, including stock analysts' reports and ratings, securities filings, and reports that track the volume and prices of various holding company securities on the public markets.

During off-site monitoring, OTS uses private sector information to supplement its analysis, including stock analysts' reports and ratings, securities filings, and reports that track the volume and prices of various holding company securities on the public markets. Such information helps identify issues to discuss with management. In addition, in enterprises that have functionally regulated or foreign-regulated affiliates, OTS will leverage their information and resources.

Reviewing public reports and key financial data is effective for identifying and mitigating potential problems without disrupting the day-to-day operations of the holding company enterprise. Communication with management between examinations enhances supervisory efforts, and keeps the agency informed of any changes in strategic direction or significant transactions. Section 800, Off-site Monitoring, provides an overview of the information OTS collects. It suggests specific ratios for monitoring financial trends. Examiners can use this information to identify outliers and shifts in trends that will often prompt an informal inquiry.

The On-site Examination

OTS conducts full-scope, on-site holding company examinations of Category I and most Category II holding company enterprises concurrently with the lead insured thrift on a 12 or 18-month cycle, depending on the size and rating of the thrift. OTS may also conduct limited or targeted reviews to address specific issues or to follow-up on prior corrective action. In addition, OTS may conduct compliance, information technology or other specialty examinations of the thrift holding company

[5] 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.

enterprise if the operations warrant. OTS assesses holding companies to cover the cost of ongoing supervision and examination.[6]

The holding company examination focuses on the entire holding company enterprise as opposed to individual registered holding companies. This is the case even if you devote most of your review to one company within the structure. You must consider the organizational structure of the holding company enterprise to determine where the risks lie and where you will devote examination resources. This approach does not imply that you will conduct an in-depth review of every company within the structure. Instead, you will determine the scope based on the risk and complexity of each holding company enterprise.

The holding company examination focuses on the entire holding company enterprise as opposed to individual registered holding companies.

In most cases, you will perform one holding company examination, even if multiple tiers of indirect ownership exist. For ease of reference, OTS stores this examination electronically under one docket number usually the holding company that is responsible for paying the assessment. You may need to conduct separate examinations when multiple holding companies with distinct ownership paths control the thrift.

You will document the examination in a report and assign a composite rating for each full scope examination. In addition, you will assign specific component ratings for complex or higher risk holding company enterprises (Category II) and Conglomerates (Category III). Section 200, Administration, contains more specific instructions on these aspects of the holding company examination.

Continuous Supervision

Dynamic and complex holding company enterprises require continuous monitoring and examinations from a dedicated and focused examination staff. Continuous supervision combines on-site examination work, routine communications, and off-site planning, monitoring, and analysis into one ongoing supervisory process. OTS uses the continuous supervision program for the most complex thrifts and holding company enterprises. Category III Conglomerates and certain Category II complex enterprises are subject to the continuous supervision program. The continuous supervision program includes developing planning documents; performing targeted reviews; annually aggregating findings, recommendations, and corrective actions into a roll-up report of examination; and assigning examination ratings. See Appendix 200B for a summary of the key elements of continuous supervision.

[6] 12 CFR Part 502 outlines how holding company assessments are calculated and the fees OTS charges.

RISK-FOCUSED APPROACH

Determining Scope

Holding company examinations are risk-focused. The primary objective is to examine the holding company enterprise in the areas that present the greatest degree of risk to the condition of the overall enterprise or to any material subsidiary, including the thrift.

The initial examination scope should target the areas 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; and
- Examination procedures will not incorporate every possible aspect of a full-scope examination.

You must carefully focus and tailor each examination to evaluate activities or operations with a high risk profile, including risks that have a direct impact on the thrift relationship or indirectly pose higher than normal risk to any material subsidiary, including the thrift. This risk-focused approach results in efficient management of 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.

> You should use judgment to determine the level of review, testing, and analysis necessary.

There is no predetermined limit on the examination scope. You may expand the scope if additional information indicates a greater degree of risk. Events that may lead to an expansion in examination scope include:

- Inadequate, inaccurate, or misleading information in regulatory filings or frequent revisions to those filings;
- Numerous intercompany or insider transactions 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;
- Substantial changes in operations and financial condition;
- Poor financial condition, inadequate cash flow, or high leverage;
- The companies within the holding company are highly integrated;

- The funds allocation processes within the holding company enterprise are cause for concern or adversely affect the thrift's financial resources through management fees, cash dividends, excessive tax payments, or affiliated transactions;

- The prior holding company examination, thrift subsidiary examination, or examinations of other regulated financial activities in the enterprise, revealed significant concerns;

- A national credit rating service downgrades the credit rating of debt issued by corporate entities in the holding company enterprise, especially if the downgrade is to a noninvestment grade; or

- The stock price of a publicly traded company in the holding company enterprise declines 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 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 noncomplex and 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, including Conglomerates (Category III), contained in Section 900.

The remaining sections of this Handbook parallel the primary areas of review in a holding company examination. These areas of review also parallel the component rating factors. Examiners should assign component rating factors for all Category II and III holding company enterprises. You may assign component ratings to Category I holding company enterprises at your discretion. The "CORE" component factors are:

C	Capital
O	Organizational Structure
R	Risk Management
E	Earnings

Capital

The first component of a holding company examination is an evaluation of ***Capital***. OTS does not apply a standardized capital requirement for savings and loan holding companies. The population of thrift holding companies is too diverse to develop a single, meaningful capital requirement. Instead, the agency considers the overall risk profile of the consolidated entity on a case-by-case basis. This involves assessing traditional analytical measures, including the overall leverage, the level of short-term debt and liquidity, cash flow and reliance on thrift and other subsidiary earnings, interest coverage, quality of earnings, and level of consolidated tangible and equity capital. The objective is to ensure that the holding company enterprise maintains adequate capital to support its risk profile and to meet the minimum capital standards of any regulated financial sector (banking, securities, or insurance) in which it operates. Another objective is to ensure that an appropriate equity buffer exists to shield the thrift from unexpected problems within the enterprise. OTS can require holding company enterprises to meet individualized capital requirements when capital adequacy is a concern.

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 the inherent risks associated with those activities as well as strategic importance to the enterprise. During the Organizational Structure section of the examination, you will reach conclusions about the:

- Lines of business/activities and the inherent risks they pose;
- Concentrations of risk; and
- The nature and volume of intra-group transactions and significant intercompany relationships.

Risk Management

In the ***Risk Management*** component, you will assess the board and executive management's ability to identify, measure, monitor, and control risk within the holding company enterprise. Managing risk is fundamental to the success of any business venture. OTS expects holding companies to have adequate risk management practices, including strong corporate governance and a system of internal controls. Such risk management practices should be commensurate with the size and complexity of the holding company enterprise. In assessing risk management, you will reach conclusions about:

- Whether the board of directors provides adequate oversight for the affairs of the holding company and its subsidiaries;
- How actively the holding company is involved in the management of the thrift institution and other regulated financial institutions; and
- Whether the board has implemented effective policies and procedures to ensure that appropriate holding company affiliates maintain separate corporate identities and avoid conflicts of interest.

Earnings

In the ***Earnings*** component, you will assess the holding company's operations, financial condition, and the current and prospective effect on subsidiaries, including the 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 and the overall financial performance of the holding company enterprise.

SUMMARY

Examination and supervision of holding companies is an important part of OTS's supervisory program. Your examination work should assess the condition of the holding company enterprise and ensure that the operations of the holding company do not harm the thrift subsidiary. OTS categorizes the thrift holding company population based on risk and complexity. This approach ensures better resource allocation for the examinations of complex or higher risk holding company enterprises.

The following section, Administration Section 200, outlines procedures for implementing this approach along with other examination elements. Other sections of this Handbook provide guidance to help you assess the CORE holding company examination areas. The Sections in the 900 series highlight additional considerations for specialized holding company populations.

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 502	Assessments and Fees

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

Other References

Applications Processing Handbook

Thrift Financial Report Instruction Manual

Introduction

The holding company examination process entails examination planning, on-site examination, off-site monitoring, and post examination coordination. Examination planning is important in categorizing risk, developing examination plans, and allocating resources. Off-site monitoring is essential for prioritizing examination scheduling and staying informed on key changes or trends. The on-site examination work must be attentive to ongoing findings and reactive so that examiners can adjust the scope accordingly. The examination culminates in presenting findings to holding company management and the directorate, completing a 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.

EXAMINATION AUTHORITY

The holding company examination assesses the overall condition of the entire holding company enterprise, including the effect that the holding company enterprise has on the subsidiary thrift and other regulated financial subsidiaries. OTS has authority by statute (12 USC 1467a(b)(4)) and by regulation (12 CFR 584.1) to conduct examinations of savings and loan holding companies, their affiliates, and their subsidiaries. OTS's examination authority does not cover holding companies that own both a bank and a thrift. The Federal Reserve Board regulates those holding companies.

LINKS
Appendix A
Appendix B
Appendix C

The Gramm-Leach-Bliley Act established provisions regarding functional supervision of holding company subsidiaries. When a subsidiary of a thrift or a thrift holding company has a functional regulator, OTS relies on the examination and conclusions of the functional regulator. The provisions regarding functional supervision limit regulatory duplication and outline procedures for requesting information and conducting examinations of certain types of entities. OTS applies a similar methodology to foreign-regulated subsidiaries. The agency has established multiple information sharing agreements to facilitate communication with both functional and foreign supervisors.

REGULATORY COORDINATION AND COMMUNICATION

Regional Responsibility

OTS normally determines regional examination responsibility for the holding company enterprise by the geographic location of the thrift. In many cases, regional authority is clear (i.e. unitary holding companies or multiple holding companies whose thrifts are within the same region). In other situations, the authority is less clear (i.e. multiple holding companies that own thrifts in several regions).

Regional offices should coordinate with OTS headquarters to determine responsibility for complicated ownership structures. For example, a multiple holding company typically owns a "lead" institution. Often, the region with the lead institution should assume responsibility for the enterprise. In the few cases where OTS cannot easily identify a lead thrift, the regions concerned must determine examination responsibility. In many cases, it is more efficient for regions to share responsibility for the on-site work due to the geographic location of files and records. As a result, communication between regional offices and OTS headquarters is essential to ensure that there are no conflicts, duplications of effort, or omissions.

Coordination with Other Regulators

Communication with other regulators is essential. You should make every effort to coordinate examination and supervisory efforts with all other interested regulators. This includes federal and state banking regulatory agencies, functional regulators of other financial activities (for example, the Securities and Exchange Commission (SEC), state insurance supervisors, the Financial Industry Regulatory Authority (FINRA)), and foreign regulators who supervise subsidiaries and affiliates of OTS-supervised holding companies and thrifts.

You should make every effort to coordinate examination and supervisory efforts with all other interested regulators.

Functional Regulation

The Gramm-Leach-Bliley Act modified OTS's holding company examination authority to recognize the involvement of multiple regulators in supervising an enterprise that offers a variety of financial products. As part of examination scoping, you need to determine whether any entity within the holding company enterprise is "functionally regulated." Functionally regulated entities include:

- Registered broker-dealers. The SEC and the FINRA regulate broker-dealers.
- Registered investment advisers with respect to investment advisory and incidental activities. Either the SEC or states regulate investment advisers.
- Registered investment companies. The SEC regulates registered investment companies.
- Insurance companies (including agencies) with respect to their insurance and incidental activities. Individual state insurance regulatory agencies regulate insurance companies.
- 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, follow the procedures outlined below. There is no restriction within the legislation on examining the holding company itself. Therefore, even if a holding company is a functionally regulated entity, you may examine it under OTS's regulatory authority. Nonetheless, you should be sensitive to the role of other regulators and strive to coordinate regulatory efforts where practicable.

General Steps in the Examination Process

Step 1 – Using Available Information

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

- Reports it submits to its primary regulator;
- Information that it reports publicly; and
- Externally audited financial statements.

You may obtain this information from the affiliate or from other sources. 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 and 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 or reports prepared for the affiliate's board of directors.

Step 2 – Requesting Information through the Primary Regulator

If you need further information, OTS can request it from the functional regulator. You should coordinate these requests through 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 request the information directly from the functionally regulated affiliate. You should coordinate and consult with your functional regulation contact before making a request. Your functional regulation contact has day-to-day experience in working with the designated functional regulators. 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 OTS has 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.

Rely, to the fullest extent possible, on the examination reports and other data the entity's functional regulator supplies. The only way to achieve the legislative goal of reducing duplication is by sharing information and working closely with other state and federal regulators.

Step 4 – When to Pursue an Examination

If you cannot address your concerns with the information made available in the preceding 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] If you have concerns after reviewing all the information you have acquired, you must 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 engages in activities that pose a material risk to the insured thrift;
- 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:
  - The affiliate is not in compliance with a federal law that OTS has specific jurisdiction to enforce, including laws that cover transactions with affiliates; and
  - OTS 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:
  - Nature of operations and financial condition of the holding company and the functionally regulated entity;
  - Financial and operational risks within the structure that may threaten the safety and soundness of a thrift; or
  - Systems for monitoring and controlling financial and operational risk.

OR

- To monitor compliance with any Federal law that:

  — OTS has specific jurisdiction to enforce against the functionally regulated entity; or

  — 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.

Interagency cooperation and exchange of information will facilitate OTS's role of ensuring the viability of the holding company enterprise, including the safe and sound operation of the thrift.

Foreign Coordination

Because some OTS-regulated entities, particularly complex holding companies, have foreign operations, you should evaluate the supervisory findings of foreign supervisors. The Joint Forum and the Basel Committee on Banking Supervision have produced several policy papers regarding cross-border supervisory cooperation.[2] OTS uses these standards as a guide for its interaction with foreign supervisors.

Using the nomenclature of "home" and "host" supervisor, the Joint Forum/Basel principles obligate the host supervisor (the supervisor of a foreign-owned subsidiary or branch) to supply to the home supervisor (the consolidated supervisor of a cross-border group) information about the operations of the subsidiaries within its jurisdiction. When OTS is the host supervisor, it will supply relevant information on its holding company or thrift, including exam reports, to the consolidated home supervisor of the parent company.

The home supervisor is expected to provide the host supervisor with any information about developments that may materially affect regulated subsidiaries in the host jurisdiction. The home supervisor is also encouraged to provide general information that would assist a host supervisor in understanding the foreign operations it supervises. When OTS is the home supervisor, it relies extensively on the examination work of foreign supervisors to identify and resolve material concerns. As home supervisor, OTS will provide relevant information in response to a host supervisor's request or to avoid a significant

[1] OTS may not, however, examine a registered investment company.
[2] www.bis.org/publ/joint02.pdf and www.bis.org/list/bcbs/tid_24/index.htm

adverse consequence. However, OTS generally does not provide holding company examination reports to host supervisors, instead summarizing information to provide relevant facts to the host supervisor.

General Steps in the Examination of Foreign Subsidiaries and Affiliates

Dealing with a foreign regulator has many similarities to dealing with a functional regulator, but there are some significant differences. Legal, regulatory, accounting, linguistic, and other differences between the U.S. and foreign jurisdictions complicate communications. In addition, the circumstances under which it is appropriate to make requests of a foreign regulator are less restrictive than for a functional regulator.

Step 1 – Using Available Information

You should gain information about the foreign affiliate by obtaining and reviewing publicly available information, such as externally audited financial statements, as well as internal documentation available from the OTS-supervised parent. The parent should have information to monitor its foreign investment and 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 or reports prepared for the affiliate's board of directors.

Step 2 – Requesting Information from a foreign supervisor

To supplement the information received in Step 1, it is desirable to confer directly with a foreign supervisor. OTS may request exam reports, submit specific written questions, or hold conference calls to gather information from foreign regulators about affiliates in their jurisdictions.

Examiners should be aware that there are variances in rules, regulations, accounting practices, currency values, communication protocols, and business customs in foreign jurisdictions. OTS's international affairs office contact can provide information regarding these differences for the jurisdictions you are reviewing.

OTS has entered into regulatory cooperation and information sharing agreements with many foreign regulators. These agreements facilitate communication and the exchange of information between regulators, including the exchange of each agency's respective examination reports. In certain cases, OTS hosts supervisory meetings in which several foreign regulators participate at once to discuss group wide supervisory issues.

Step 3 – Conducting a review of a foreign entity

In the course of developing supervisory plans for your firm, you may find it necessary to examine a foreign entity in order to adequately review an activity or risk exposure on a firm-wide basis. For example, you may need to meet with the management of a foreign subsidiary to evaluate the degree to which the parent company disseminates its policies throughout the organization. If a foreign subsidiary generates a significant portion of the revenue or profit of a business line, it may be valuable to examine how that subsidiary manages the risks inherent in that business.

Because the ability to examine a foreign firm falls outside of U.S. law, OTS authority to supervise the foreign entity is not as clear as its authority for functionally regulated entities. As a result, OTS will need to coordinate with the foreign supervisor of the affiliate.

Foreign-Based Holding Companies

Foreign-based holding companies present OTS with additional challenges. The geographic location of foreign-based holding companies and their supervision by home supervisors make it more difficult to perform holding company examinations. Examiners should rely on information that home supervisors provide. However, a foreign firm that charters a thrift must sign the *Foreign Acquirer Agreement*, in which it agrees to submit to OTS supervision of the top-tier holding company. If an examination is necessary, OTS must coordinate it with the home country supervisor. OTS senior management must approve the decision to conduct an examination of a foreign holding company.

EXAMINATION PLANNING

Before initiating the on-site examination, OTS must identify and categorize risk and allocate resources. During examination planning, OTS requests information from the holding company and other regulators to ensure that it is available when the formal examination begins. To complete examination scoping, you must understand the holding company enterprise and the industries in which it operates. In many situations, the individual responsible for ongoing monitoring may not be the same person who conducts the 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 examination planning to gain requisite knowledge. These procedures include reviewing sources of information on the holding company enterprise including:

- Reports generated by the OTS databases;
- Reports submitted to OTS;
- Reports submitted to other regulators such as the SEC; and
- Prior examination reports, work papers, and supervisory correspondence.

Once you achieve the requisite understanding of the holding company enterprise, you should prepare and send the preexamination response kit (PERK). (Appendix 200A contains a sample PERK. Determinant questions are used to eliminate questions that are not relevant, for example, if the holding company is noncomplex, has no significant activities other than control of the thrift, and has no significant debt, many of the questions will automatically be deleted by the system and the PERK that you download is a simplified version.)

One of the most important steps in examination planning 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 application process resulted in the correct risk category. Your review will contribute to the risk-focused scope and allocation of examination resources.

Holding Company Risk/Complexity Classifications

The Administrative Program contains a Risk/Complexity Classification Checklist that you should use to determine the enterprise's complexity. The initial questions determine if the enterprise is a low risk, noncomplex holding company. If the result is that the holding company is low risk and noncomplex, then the checklist concludes. Noncomplex entities require minimal examination, and you will use the Abbreviated Holding Company Examination Program contained in Section 720 of this Handbook. If the initial review indicates that the enterprise is higher risk or complex, you should continue the checklist to assess the nature and degree of the risks. The questions in the program will help assess the level of risk. The checklist also directs you to sections of the CORE Holding Company Examination Program, Section 730, to evaluate the potential risks that you identify.

Once you complete the checklist, you should designate the appropriate risk category. You may modify your preliminary assignment during the examination based on your findings. At the close of the examination, you should update the appropriate risk/complexity category classification in the Holding Company Examination Data System. You must document a change in the risk/complexity category in a Holding Company examination. Regional management should review and approve all examination ratings and risk/complexity classification changes before notifying the holding company or changing the classification on the system.

Category I holding company enterprises are noncomplex and low risk. An examination of this type of entity requires limited resources. You should use the Abbreviated Program (Section 720). You may supplement the abbreviated procedures with sections of the CORE Holding Company Examination Program (Section 730) when you note higher risk activities. At a minimum, you should conduct the procedures that relate to the "yes" responses on the Risk Classification Checklist.

Category II or III holding company enterprises are complex and exhibit elements that are higher risk. The examination may require greater resources to review the current and prospective risks of the enterprise. You should review all procedures of the full CORE Holding Company Examination Program. Use judgment to determine which procedures you actually perform. You should also review and follow the procedures in Section 940 for a Category III enterprise.

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
Category III – Conglomerate	CORE HC exam Program Section 730 in conjunction with Section 940. Risk Matrix and Supervisory Plan outline of priorities.	To develop and amend the risk assessment and supervisory plan under OTS's continuous supervision program for conglomerates.

ON-SITE EXAMINATION

In most cases, the on-site holding company examination will coincide with the examination of the insured thrift subsidiary. In cases where management of both entities overlaps, you can coordinate entrance and exit meetings with the thrift examination. However, you must ensure that you complete your examination work for the holding company examination 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, you should use the protocols and techniques of a thrift examination for the holding company as well. These include protocols of professional behavior and communication techniques such as introductory and closing meetings. You are also required to maintain adequate documentation and support for findings in examination work papers similar to the standards for thrift examination reports.

However, holding company examinations may require additional procedures that are not 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 or unregulated subsidiaries of the holding company that are significant businesses.

> Holding companies and their noninsured or unregulated subsidiaries may not be as familiar with regulatory examination practices as their thrift counterparts.

Holding companies and their noninsured or unregulated 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 in the thrift examination. Many companies, particularly significant subsidiaries with independent management, may not be aware or fully understand the scope of OTS authority in regulating the holding company enterprise. You must maintain professional conduct and attempt to achieve an understanding with managers regarding their regulatory responsibilities. If difficulties persist, you may need to request that OTS senior management become involved in order to influence a more cooperative working relationship.

Continuous Supervision

Dynamic and complex holding company enterprises require continuous supervision from a dedicated examination staff. Continuous supervision and examination combines on-site examination work, routine communications, and off-site planning, monitoring, and analysis into an ongoing examination process. OTS uses the continuous supervision program for the most complex thrifts and holding company enterprises. Category III conglomerates and certain Category II complex enterprises are subject to the continuous supervision program. The continuous supervision program includes developing planning documents; performing examination work; annually aggregating findings, recommendations, and corrective actions into a report of examination; and assigning examination ratings. The key elements of continuous supervision are:

- Developing and maintaining a comprehensive risk assessment
- Preparing a supervisory plan
- Scheduling and conducting targeted reviews
- Coordinating with other domestic and foreign regulators
- An annual, roll-up examination process and reporting framework
- Routine management meetings and an annual board of directors meeting
- Appendix 200B provides a detailed explanation of each element of continuous supervision.

PostExamination Procedures

Once an on-site examination is complete and you have resolved all outstanding factual issues, you must communicate your findings to senior management and the board of directors, or an appropriate committee of the board. 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 should be with executive managers, but may involve directors of the holding company as well. The closing meeting serves several purposes. It summarizes the examination and advises senior officials of the conclusions in the report of examination. It also ensures that all parties clearly understand the issues and are able to satisfactorily resolve or monitor unresolved issues. If thrift and holding company management overlap, then you may combine the presentations for both the holding company and thrift examination. However, separate presentations are appropriate if the findings of either or both examinations are significant.

Meetings with the Board of Directors

As with thrift examination exit meetings, holding company examinations resulting in composite ratings of 4 or 5 require you to meet with the board of directors or an appropriate committee of the board. OTS also requires a board meeting when the examination results in a downgrade to a composite 3 during the examination. Regardless of the rating, it is appropriate to meet with the board or its designated committee in complex holding companies, holding companies with persistent violations of laws or regulations, or holding companies that present a materially adverse effect on the subsidiary thrift. Consult with your manager to determine whether you should schedule a meeting with the board of directors. The scope of the meeting should include holding company examination findings and conclusions, necessary corrective actions, and discussions concerning possible enforcement remedies, when applicable. You should finalize the report of examination before conducting this meeting with the board of directors.

The Report of Examination

A final report of examination should fully discuss the significant issues you identify. The report format corresponds to the major examination areas in this Handbook. It also includes background information on the holding company enterprise as well as information regarding the directorate and executive officers. The report may also include schedules providing financial information. Appendix 200C contains a copy of the Holding Company Report of Examination shell.

Rating the Holding Company Enterprise

An integral component of the examination report is the holding company rating. Once you complete the examination, you must assign a composite rating to the holding company enterprise. The rating becomes part of a valuable management information system from which supervisory personnel can monitor OTS's level of concern with the holding company enterprise's performance. You will disclose the composite and component (when assigned) ratings to the holding company and include them in the examination report.

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

For Category II and III holding company enterprises,[3] you will rate these four components on a scale of one to five in descending order of performance quality. The component ratings encompass the full nature of the enterprise by:

[3] 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.

- 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 whether management and the board of directors implement appropriate **risk management** strategies – **“R”**; and
- Assessing the **earnings** performance and liquidity of the enterprise as a consolidated entity – **“E”**.

This system requires you to consider all aspects of the organization’s performance. You will assess the separate units and businesses for their contribution to the financial strength of the holding company enterprise as well as the condition of the enterprise as a whole for its financial soundness. You will note problems whether they are isolated or throughout the enterprise. For example, individual entities may exhibit satisfactory condition but, on a consolidated basis, it becomes evident that consolidated capital does not support inherent risks. Conversely, the consolidated enterprise may be financially strong with good performance, yet there may be subsidiaries that exhibit current or prospective risk that you need to reflect in the rating. The resultant composite rating will be a product of this subjective determination process.

The Composite Rating

The composite rating is the overall assessment of the holding company enterprise as reflected by consolidated risk management and consolidated financial strength. The composite rating encompasses both a forward-looking and static assessment of the consolidated enterprise. Consistent with current OTS practice, you should not derive the composite rating as a simple numeric average of the CORE components; rather, the composite rating should reflect your judgment with respect to the relative importance of each component to the safe and sound operation of the holding company enterprise. Some components may receive more weight in determining the composite rating, depending on the situation of the holding company enterprise. Assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the holding company enterprise, although generally the composite rating bears a close relationship to the component ratings. Your judgment is essential to give the appropriate weighting to the components. The definitions of the composite ratings are:

Some components may receive more weight in determining the composite rating, depending on the situation of the holding company enterprise.

Composite 1. Holding company enterprises in this group are sound in almost every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. Risk management practices and financial condition provide resistance to external economic and financial disturbances. Cash flow is more than adequate to service debt and other fixed obligations. These holding company enterprises exhibit the strongest performance and risk management practices relative to their size, complexity, and risk profile.

Composite 2. Holding company enterprises in this group are fundamentally sound but may have modest weaknesses. The weaknesses are well within the board of directors' and management's capabilities and willingness to correct. For holding company enterprises to receive this rating, generally no component rating should be more severe than 3. Risk management practices and financial condition create stability and these holding company enterprises are capable of withstanding business fluctuations. Cash flow is adequate to service obligations. Overall, risk management practices are satisfactory relative to the enterprise's size, complexity, and risk profile.

Composite 3. Holding company enterprises in this group exhibit some degree of supervisory concern in one or more of the component areas with weaknesses that range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. These holding company enterprises are less resistant to the onset of adverse business conditions. Risk management practices may be less than satisfactory relative to the enterprise's size, complexity, and risk profile. However, there is only a remote threat to its continued viability.

Composite 4. Holding company enterprises in this group have serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Holding company enterprises in this group are generally not capable of withstanding business fluctuations. Risk management practices are generally unacceptable relative to the enterprise's size, complexity, and risk profile. Cash flow needs may be being met only by upstreaming imprudent dividends or fees from its subsidiaries. Unless prompt action is taken to correct these conditions, future viability could be impaired.

Composite 5. The magnitude and character of the risk management or financial weaknesses of a holding company enterprise in this category could lead to insolvency without immediate aid from shareholders or supervisory action. The volume and severity of problems are beyond the board and management's ability or willingness to control or correct. The effectiveness of the organizational structure and risk management practices are inadequate relative to the enterprise's size, complexity, and risk profile. The inability to prevent liquidity or capital depletion places the holding company enterprise's continued viability in serious doubt.

The purpose of rating the holding company, consistent with OTS's risk-focused supervisory approach, is to reflect your assessment of the holding company enterprise, consolidated risk management, and consolidated financial strength. It is essential to coordinate your findings with the examiners conducting the thrift examination. One aspect of the holding company examination is your assessment of the impact on the thrift. You must consider the risks and positive or negative effect of the holding company relationship 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. Your assessment should reflect the current financial and operating situation of the holding company enterprise as well as its 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

Because OTS normally conducts concurrent examinations of the thrift and the holding company, you should integrate the findings from both examinations. The holding company examination report is the primary method to discuss 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. The examiners-in-charge for both entities should discuss the issues and conclusions. The thrift examiner-in-charge 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, these activities may cause a greater funding need from the thrift. The capital comment in the thrift report should reflect this potential dividend requirement. In addition, 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. It is also appropriate to comment if the thrift is dependent on the holding company and its affiliates for operational support.

Examination Follow-Up

After the completion of an examination, you should document required supervisory follow-up to examination findings and matters requiring board attention or management corrective actions. Responsible staff should: (i) enter matters requiring board attention or holding company actions in the examination follow-up system of EDS/ROE; (ii) ensure that the holding company takes timely and appropriate corrective action for any problems identified during the examination; (iii) closely monitor (during the examination and through ongoing offsite monitoring) compliance with matters requiring board attention and other required corrective actions; and (iv) promptly identify and appropriately address any significant noncompliance or recurrence of identified problems.

Enforcement Actions

The same supervisory and enforcement tools that are available to address supervisory concerns at the thrift are also available to address concerns within the holding company enterprise. For a full description of enforcement actions, please refer to Examination Handbook Section 080, Enforcement Actions.

Summary

Comprehensive supervision of thrift holding companies is a combination of off-site monitoring and on-site examinations. Off-site monitoring and examination planning analysis aid in identifying trends, defining the risk classification of the holding company enterprise, and establishing a preliminary scope of the examination. In the case of conglomerates and certain other complex enterprises, supervision of the enterprise may require continuous supervision. Continuous supervision is an ongoing combination of on-site examination work, routine communication, off-site planning, monitoring, and analysis. When conducting an examination, you must maintain a professional and cooperative relationship with holding company management and directors, as well as other interested functional and foreign regulators.

To conclude an examination, you must document your findings in a report of examination and assign a composite rating. The report may recommend appropriate actions for the holding company or implement supervisory measures to corrected problems you identify. You should also assign component ratings for all high risk or complex holding companies (Category II) and conglomerates (Category III). You will disclose the ratings to the holding company and include them in the examination report. You should communicate the examination findings to senior management and the directors of the holding company, as well as to other interested regulators. You should recommend necessary follow-up action to address outstanding issues and monitor compliance with matters requiring board attention and other required corrective actions. Each phase of the holding company examination 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.

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In order to facilitate the examination of the holding company enterprise, provide the information requested in this document. If the information requested for a specific inquiry does not apply to your enterprise, type "N/A." If you have already provided the same information in other examination schedules, or in regular Securities and Exchange Commission (SEC) filings transmitted to OTS, you need only provide page references to where various inquiries are addressed.

The scope of the examination is the entire holding company structure. Therefore, if there is more than one registered savings and loan holding company, you must provide the required information for each holding company. If you have any questions about the information requested, or if you are seeking a waiver regarding some of the information requested on the basis that it represents an unreasonable burden, contact name of EIC at phone # or email at e-mail address .

Key definitions and explanatory notes regarding terms used in this document are set forth at the end of this document.

Please provide the requested information by Click Here and Type

Primary Contact for questions regarding responses:

Name	Title	Phone Number	Email

Custodian and location of books and records.

Name	Title	Location

The undersigned executive officer acknowledges and certifies that the information contained herein, including forms or exhibits, has been carefully reviewed, and that such information is true, correct and complete.

Attest:

Name Title Date

Signature

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Response Due

Start	21.1	If not discussed in your business plan, describe your strategy for maintaining a sufficient amount of capital relative to the overall risk profile of the enterprise.
Start	21.2	Describe how changes in the enterprise's risk profile are reflected in changes in your estimation of "sufficient capital."
Start	21.3	How does your current capital level compare with what your strategy projects as the minimum level of capital needed to support your current risk profile?
Start	21.4	In your calculation of capital, how much consists of debt instruments like trust preferred or other hybrid securities and GAAP intangible assets such as servicing?
Start	21.5	When comparing your current capital to what you project as the minimum capital you need, do you count all capital the same, or do you apply a discount to such items as debt instruments and intangible assets?
Start	21.6	If any of your securities are rated, describe the rating you are seeking or trying to maintain, as well as any steps you are taking to achieve or maintain the desired rating.

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Start 21.7 Explain your policy with respect to any possible need to provide your savings association with additional capital.

Start 21.8 If you or your subsidiaries have issued any new capital stock or capital notes since the last report of examination, provide the following details of the transaction(s):

Class	Amount Issued/ Previous Amount Outstanding	Description of Transaction (price, date, seller, net cash received, use of proceeds)

Start 21.9 If you or your subsidiaries have outstanding or committed debt, provide the following details of the transaction(s):

Outstanding or Committed Debt			
Date of Borrowing:	Type Here	**Maturity Date:**	Type Here
Name of Lender:	Type Here	**Original Amount:**	Type Here
Amount Outstanding:	Type Here	**Interest Rate:**	Type Here
Rating	Type Here	**Rating Agency:**	Type Here
Type of Debt:	Type Here		
Purpose:	Type Here		
Other Terms:	Type Here		
Covenants or Restrictions:	Type Here		

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Start 21.10 If you or your subsidiaries have outstanding hybrid securities, provide the following details of the transaction(s). Include all securities that are not purely debt or equity.

Outstanding Hybrid Securities			
Date of Issuance:	Type Here	**Maturity Date:**	Type Here
Public Offering or Private Placement:	Type Here		
Amount of Issuance:	Type Here	**Callable Date:**	Type Here
Rating	Type Here	**Rating Agency:**	Type Here
Rating	Type Here	**Rating Agency:**	Type Here
Type of Security:	Type Here		
Purpose:	Type Here		
Other Terms:	Type Here		
Covenants or Restrictions:	Type Here		

Start 21.11 Describe any scheduled debt or equity offerings.

Class	**Amount to be Issued/ Net Cash Proceeds Expected**	**Anticipated Use of Proceeds**

Start 21.12 If you have repurchased any of your capital stock since the last report of examination, provide the following information:

Date of Repurchase/ Class of Stock	**Amount Repurchased/ Average Price per Share**	**Remaining Shares Outstanding/ Percentage of Capital Repurchased**	**Name of Seller* (if applicable)/ Terms of Repurchase (if applicable)**

*If you have repurchased stock from insiders or related parties, indicate the name of the individual(s) or party(ies), as well as the terms of such repurchases.

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Start 21.13 If you anticipate any major changes in your dividends, or plan any further share repurchases, provide details.

Start 21.14 If there has been any adverse change in the condition of your debt or equity securities since the last report of examination, such as default or a restructuring in anticipation of a default, provide the following details:

Class of Securities	Total Amount of Principal	Amount in Arrears	Nature of Problem

Start 21.15 If any debt is secured by a pledge of the savings association's capital stock, provide the following:

Lender/ Percent of Shares Used as Collateral	Loan Date/ Maturity/ Current Balance	Loan Amount/ Interest Rate	Description of Use of Proceeds, Conditions of Forfeiture and Current Status

Start 21.16 If you have made advances to the savings association since the last report of examination, describe whether the association has been reporting the funds as debt or equity.

If debt, describe the terms, including the amount borrowed.

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Start 21.17 Provide details on any of the savings association's liabilities or contingent liabilities that are guaranteed by you or another affiliate.

Start 21.18 Provide details on any liabilities or contingent liabilities of you or your affiliates that are guaranteed by the savings association.

Start 21.19 Provide the following information on any other loans, advances, liabilities or other obligations, for which you have pledged security, or otherwise have guaranteed, that has not been reported as a liability on your financial statements:

Date of Guarantee/ Amount	If Secured, Describe the Type of Security	Description of Obligation and Explanation Why You Needed to Provide a Guarantee

Start 21.20 If you have any financial industry subsidiaries which have minimum required capital levels, provide the following information:

Subsidiary Name/ Location	Primary Regulator/ Location	Minimum Required Capital	Current Capital Level

If you, or any of your regulated financial industry subsidiaries fail to meet minimum required capital levels, explain the circumstances.

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If you, or any of your regulated financial industry subsidiaries are subject to any enforcement actions, explain the circumstances.

Start 21.21 Organization chart showing all major subsidiaries and the applicable ownership. Provide a brief description of subsidiary activities and summarize any changes in your organizational chart since the last report of examination.

Start 21.22 Provide the North American Industry Classification System (NAICS) code of the business activity that produces the highest portion of your consolidated gross revenue. (See Appendix for a summary of NAICS sector codes.)

Start 21.23 Excluding the savings association, list the three subsidiaries that contribute the greatest portion of your consolidated gross revenue.

Name and Address	NAICS Code	Description of Activity

Start 21.24 Provide a list of other regulators that oversee your, or your subsidiaries, operations. Clearly identify whether you have received an examination, inspection or other similar report from them since your last examination.

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Start 21.25 Are you subject to the activity limitations as discussed in Section 400 of the OTS Holding Company Handbook?

Start 21.26 Since the last report of examination, describe any significant changes of ownership or management.*

If you are contemplating changes, describe the planned changes.

*If a new executive officer or director has been appointed or elected, submit the following information, *if not already provided*, for each new director or officer:

- A resume summarizing relevant experience; and,
- A description of any current position as director, officer, employee or controlling beneficial stockholder of any nonaffiliated savings association or savings and loan holding company.

Start 21.27 If you, directly or indirectly, or through one or more of your subsidiaries, or any of your insiders, partners or trustees;

- hold any of the voting shares of a savings association or savings and loan holding company that is not a subsidiary; or
- acquire control of a new subsidiary savings association (insured or uninsured) or savings and loan holding company during the review period; or
- acquire additional shares or voting securities of a previously held subsidiary savings association or savings and loan holding company during the review period; or

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- hold any proxies with respect to any voting rights in a mutual savings association, then provide the following information for each stock savings association or savings and loan holding company:

Name of Acquirer	Nonaffiliated Savings Association or Holding Company	Class of Stock Held	Method of Ownership or Control	Number of Shares/ Percent of Total Shares

And provide the following information for each mutual savings association or savings and loan holding company:

Name of Acquirer/ Number of Shares or Proxies Acquired	Date Shares or Proxies Acquired/ Percent of Proxies Acquired	Number of Voting Rights Held by Proxy/ Percent of Voting Rights Held by Proxy	Term of Proxy

Start 21.28 If you are a partnership, provide the following information on all persons or entities that have contributed, or are planning to contribute, 10% or more of the capital of the partnership:

Name and Address of Contributor	Type of Partner	Percent of Total Capital Contributed

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Start 21.29 If you are a trust, provide the following information on all persons who have more than 10% beneficial interest:

Name and Address of Beneficiary	Type of Trust/ Trustee	Percent of Beneficial Interest

Start 21.30 Identify any threatened or pending litigation not listed in the Management Letter of Representation involving you or your non-thrift subsidiaries either as Plaintiff or Defendant. DO NOT include foreclosures in this listing, or other routine litigation incidental to the company's business. For each such matter, explain:

- The claim and the stage of the proceeding. Include the probable trial date.
- How Management is responding or intends to respond to the claim. Will the claim be vigorously contested or will an out of court settlement be sought?
- The amount being litigated, and an estimate of the amount of the potential loss or recovery or the range of such loss or recovery.
- The probable effect any such litigation will have on you or your subsidiaries.

Start 21.31 Describe the policies and screening processes you employ to identify individuals that may be prohibited from serving at a savings and loan holding company as a result of a conviction of a criminal offense involving dishonesty, breach of trust, or money laundering. (See 12 CFR Part 585 and 584.9.) Identify and furnish complete details regarding any individuals covered by Part 585 or 584.9 that are currently in your employ and have been convicted (or agreed to enter into a pretrial diversion of similar program in connection with a prosecution for such an office).

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Start 21.32 Describe any administrative proceedings that are adverse to you or any of your subsidiaries and that involve any of your or your affiliates' directors, executive officers, partners, trustees; or their associates (as defined in 12 CFR 563b.25); or involve the related interests of any such person.*

Agency or Court Hearing the Case	Initiation Date of Proceedings	Principal Parties to the Proceeding	Brief Summation of the Case, Including any Proposed or Assessed Fines or Penalties

*Include similar information as to any such proceedings known to be contemplated by governmental or professional authorities, by indicating "Uncertain" under "Initiation Date of Proceedings."

Start 21.33 If you or any of your affiliates offers or contemplates offering financial services complementary to or in competition with the savings association (i.e., mortgage banking, commercial banking, credit life insurance, insurance agency, or escrow agency), answer the following questions:

- Are the activities coordinated with or expected to be coordinated with the savings association?

- Are any of the activities dependent on the savings association for all or most of their revenue?

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- What is the volume of business between such affiliates and the savings association?

- Is the savings association losing revenue due to such activities?

Start 21.34 If there are any loans outstanding from you or your affiliates totaling over $500,000 to any single insider, partner, or trustee, provide the following information:

Name of Borrower	Amount of Loan	Type of Loan/ Term of Loan	Payment Status

Start 21.35 If, since the last examination report, any of your insiders, partners or trustees held a controlling interest in a nonaffiliated depository institution or a nonaffiliated depository holding company, furnish the following information:

Name/ Position at Holding Company	Nonaffiliated Depository Institution or Holding Company/ Description of Controlling Interest

Start 21.36 If not addressed in the business plan, describe your corporate objectives with respect to the savings association.

Do you plan for the savings association to grow?

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- If so, what growth projections (including acquisitions) have been made?

- What assumptions were used?

What dividend flow do you expect the savings association to produce over the next three years?

What annual percentage return on investment do you expect from your investment in the savings association?

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Start 21.37 For all of your insiders, partners, trustees and ESOPs, provide the following information with respect to the shares or other securities of you or your affiliates. Include any shares or other securities held by an immediate family member.

Name / Occupation	Title/ Year Appointed	Number of Shares Owned/ Percent of Total Shares	Number of Options Owned/ Method of Ownership or Control	Amount of Any Other Securities/ Type of Securities

Start 21.38 Are there any agreements or understandings between individuals regarding the transferability and voting of any of your stock and/or the management or control of you or your affiliates? If so, provide detailed information including, but not limited to, names of the individuals and specific intentions, along with copies of any agreements.

Start 21.39 If you have an enterprise-wide Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance policy or program to manage risk, please provide the following:

- A copy of your written enterprise-wide BSA/AML compliance policy or program to include all related policies and procedures.
- A copy of your enterprise-wide BSA/AML risk assessment of the products, services, customers, and geographies in which you operate.
- The name and contact information of the individual or entity responsible for coordinating and monitoring day-to-day compliance with the enterprise-wide BSA/AML compliance policy or program.
- Where you have conducted self-assessments, periodic transaction reviews, or internal/external audits ensuring enterprise-wide BSA/AML compliance, include the standards used to govern the review and copies of written reports presented to the board and senior management detailing significant findings, deficiencies, conclusions, and recommendations for corrective action.

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- The name and contact information of the individual or entity responsible for enterprise-wide BSA/AML training.

Start 21.40 If you do not have an enterprise-wide BSA/AML compliance program, please provide a brief description of any entities or lines of business, other than the savings association, that present a significant risk of money laundering and a brief overview of the policies, procedures and processes in place to manage the BSA/AML risk associated with the identified entities or lines of business.

Start 21.41 Please identify any entities, other than the savings association, that are engaged in mortgage lending. For those identified entities, please provide a brief overview of the policies, procedures, and processes in place to ensure compliance with the Fair Housing Act, Equal Credit Opportunity Act and Home Mortgage Disclosure Act.

Start 21.42 If not described in your business plan, discuss your current earnings and cash flow projections. If you have issued any debt or stock, discuss your current earnings and cash flow projections. Include details on anticipated dividends from the thrift subsidiary for the next 12 months. If you have issued debt, provide the debt service requirements for the most recent calendar year and a projection for the current calendar year. If you pay cash dividends, provide a schedule of dividends paid for the most recent calendar year and a projection for the current calendar year.

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Explain any material deviation from projected earnings.

Explain any material deviation from projected cash flow.

Excluding the savings association, list the three subsidiaries that contribute the largest cash flows to the holding company:

Subsidiary Name(s)	Cash Flow	Percentage of your total cash flow

Start 21.43 If funds from the savings association were paid to you for purposes of income tax payments since the last examination report, provide the following information:*

Payment Date/ Payment Amount	Savings Association Income Tax Liability	Proportion of Consolidated Payment Contributed by Savings Association

*If the savings association makes payments on its own behalf, or on behalf of the consolidated structure, directly to the IRS, such payments should be listed and footnoted with appropriate clarifications.

Start 21.44 If there has been a change in independent auditors or fiscal year end, explain the reason(s) for change, date of change and identify the new auditor/date.

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Start 21.45 What effect, if any, have any changes in accounting principles and procedures had on your income?

Start 21.46 Most recent independent auditor’s reports including any management letters.

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

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(in 000s)	Most Recent Fiscal Quarter mm/dd/yyyy	Current Year-To-Date mm/dd/yyyy	Prior Fiscal Quarter mm/dd/yyyy
External Sources			
Issuance of stock	$0	$0	$0
Net increase in borrowed funds	0	0	0
Advances to subsidiaries repaid:			
Thrifts	0	0	0
Other Affiliates	0	0	0
Sale of assets	0	0	0
Total External Sources	$ 0	$ 0	$ 0
External Uses			
Net decrease in borrowed funds	$0	$0	$0
Dividend payments:			
Preferred	0	0	0
Common	0	0	0
Equity investment in subsidiaries			
Thrifts	0	0	0
Other Affiliates	0	0	0
Advances to subsidiaries:			
Thrifts	0	0	0
Other Affiliates	0	0	0
Purchase of assets	0	0	0
Total External Uses	$ 0	$ 0	$ 0
Net External Position	$ 0	$ 0	$ 0
(External Sources less External Uses)			
Net Change In Cash Position	$ 0	$ 0	$ 0
(After-tax cash income plus net external cash)			
Cash Balance Beginning	$0	$0	$0
Cash Balance Ending	$ 0	$ 0	$ 0

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1. **Net Worth Requirement**
   - a. The portion of your consolidated net worth at the close of the last preceding fiscal year on an actual or pro forma basis represented by:
     - i. Subsidiary savings association **$0.00**
     - ii. Other related business activities specified in 12 CFR Sections 584.2(b), 584.2-1, and 584.2-2. **$0.00**
   - b. Total of Line 1.a.(i) plus Line 1.a.(ii) **$0.00**
   - c. Your consolidated net worth as of same date **$0.00**
   - d. Ratio of Line 1.b to Line 1.c

2. **Net Earnings Requirement**
   - a. Net earnings for the last preceding fiscal year on an actual or pro forma basis as follows:
     - i. Total net earnings that the subsidiary savings association contributed to consolidated net earnings **$0.00**
     - ii. Total net earnings that other related business activities specified in 12 CFR Sections 584.2(b), 584.2-1 and 584.2-2 contributed to consolidated net earnings **$0.00**
   - b. Total of Line 2.a.(i) plus Line 2.a.(ii) **$0.00**
   - c. Your total consolidated net earnings for the last preceding fiscal year **$0.00**
   - d. Ratio of Line 2.b to Line 2.c

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PREPARE TO PROVIDE EXAMINER ACCESS TO THOSE ITEMS BELOW THAT ARE APPLICABLE:

- Board Packages
- Risk Management Reports
- Policies and Procedures
- Tax Sharing Agreement
- Analyst Reports from Underwriters, Credit Agencies or Security firms
- Reports dealing with Bank Secrecy Act/Anti-Money Laundering Activities
- Schedule of Investments
- Loan Trial Balance

Definitions and Explanatory Notes

"Affiliate" is defined in 12 CFR Section 563.41.

"Depository Institution" and "Depository Holding Company" are defined in 12 CFR Section 563f.2.

"Enterprise-wide" refers to compliance policies or programs that coordinate the BSA/AML regulatory requirements throughout an organization inside a larger risk management framework. Such frameworks enable an organization to have a consolidated understanding of its risk exposure to money laundering and terrorist financing across all business units, functions, and legal entities.

"Executive officer" includes the president, chief executive officer, chief operating officer, chief financial officer, chief lending officer, chief investment officer, and any other individual OTS identifies that exercises significant influence over, or participates in, major policymaking decisions of an institution or a savings and loan holding company. (12 CFR Section 215.2(e)(1))

"Insider" is defined as an executive officer, director, or principal shareholder, and includes any related interest of such a person. (12 CFR Section 215.2(h))

"Principal Shareholder" is defined as a person that directly or indirectly, owns, controls, or has the power to vote more than 10 percent of any class of voting securities of an institution or company. Shares owned or controlled by a member of an individual's immediate family are considered to be held by the individual. (12 CFR 215.2(m)(1))

"Related interest" of a person is defined as a company, partnership or other entity that is controlled by that person; or a trust or other fund which benefits that person. (12 CFR 215.2(n))

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All other terms used in this document, have the meaning commonly ascribed to them in commercial/financial usage or as specified in Section 10 of the Home Owners' Loan Act, as amended, and 12 CFR Parts 583, 574 and 561.

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Appendix

North American Industry Classification System[1]
Business Activity Sector Codes

Sector 110000-119999 —Agriculture, Forestry, Fishing and Hunting
111000 Crop Production
115000 Support Activities for Agriculture and Forestry

Sector 210000-219999 – Mining

Sector 220000-229999 — Utilities

Sector 230000-239999 — Construction
233000 Building, Developing, and General Contracting
234000 Heavy Construction

Sector 310000-339999 — Manufacturing
311000 Food Manufacturing
321000 Wood Product Manufacturing
322000 Paper Manufacturing
323000 Printing and Related Support Activities
324000 Petroleum and Coal Products Manufacturing
325000 Chemical Manufacturing
326000 Plastics and Rubber Products Manufacturing
331000 Primary Metal Manufacturing
332000 Fabricated Metal Product Manufacturing
333000 Machinery Manufacturing
334000 Computer and Electronic Product Manufacturing
335000 Electrical Equipment, Appliance, and Component Manufacturing
336000 Transportation Equipment Manufacturing
337000 Furniture and Related Product Manufacturing
339000 Miscellaneous Manufacturing

Sector 440000-459999 — Retail Trade
441000 Motor Vehicle and Parts Dealers
442000 Furniture and Home Furnishings Stores
443000 Electronics and Appliance Stores
444000 Building Material and Garden Equipment and Supplies Dealers

[1] For a detailed listing of all codes, go to www.census.gov/epcd/naics02/naicod02.htm

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445000 Food and Beverage Stores
448000 Clothing and Clothing Accessories Stores
452000 General Merchandise Stores
453000 Miscellaneous Store Retailers
454000 Nonstore Retailers

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Sector 510000-519999 — Information

511000 Publishing Industries
512000 Motion Picture and Sound Recording Industries
513000 Broadcasting and Telecommunications
514000 Information Services and Data Processing Services

Sector 520000-529999 — Finance and Insurance

522000-522999 - Banking and Finance
522110 Commercial Banking
522120 Savings Institutions
522130 Credit Unions
522190 Other Depository Credit Intermediation
522210 Credit Card Issuing
522220 Sales Financing
522291 Consumer Lending
522292 Real Estate Credit
522293 International Trade Financing
522294 Secondary Market Financing
522298 All Other Nondepository Credit Intermediation
522310 Mortgage and Nonmortgage Loan Brokers
522320 Financial Transactions Processing, Reserve and Clearinghouse Activities
522390 Other Activities Related to Credit Intermediation

523000-523999 - Securities, Commodities and Other Financial Investments

523100 Securities, Commodity Contracts, and Other Financial Investments and Related Activities
523110 Investment Banking and Securities Dealing
523120 Securities Brokerage
523130 Commodity Contracts Dealing
523140 Commodity Contracts Brokerage
523210 Securities and Commodity Exchanges
523910 Miscellaneous Intermediation
523920 Portfolio Management
523930 Investment Advice
523991 Trust, Fiduciary, and Custody Activities
523999 Miscellaneous Financial Investment Activities

524000-524999 - Insurance

524100 Insurance Carriers
524113 Direct Life Insurance Carriers

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524114 Direct Health and Medical Insurance Carriers
524126 Direct Property and Casualty Insurance Carriers
524127 Direct Title Insurance Carriers
524128 Other Direct Insurance
524130 Reinsurance Carriers
524210 Insurance Agencies and Brokerages
524291 Claims Adjusting
524292 Third Party Administration of Insurance and Pension Funds
524298 All Other Insurance Related Activities

525000-525999 - Other Financial
525100 Insurance and Employee Benefit Funds
525110 Pension Funds
525120 Health and Welfare Funds
525900 Other Investment Pools and Funds
525910 Open-End Investment Funds
525920 Trusts, Estates, and Agency Accounts
525930 Real Estate Investment Trusts
525990 Other Financial Vehicles

Sector 530000-539999 — Real Estate and Rental and Leasing
531100 Lessors of Real Estate
531200 Offices of Real Estate Agents/Brokers
531300 Activities Related to Real Estate
532000 Rental and Leasing

Sector 540000-549999 — Professional, Scientific, and Technical Services

Sector 550000-559999 — Management of Companies and Enterprises

Sector 560000-569999 — Administrative and Support and Waste Management and Remediation Services

Sector 620000-629999 — Health Care and Social Assistance

Sector 710000-719999 — Arts, Entertainment, and Recreation

Sector 720000-729999 — Accommodation and Food Services

Sector 810000-819999 — Other Services (except Public Administration)
813000 Religious, Grantmaking, Civic, Professional, and Similar Organizations

CONTINUOUS SUPERVISION

OTS uses a continuous supervision program for our most complex savings associations and holding companies. OTS determines on a case-by-case basis whether to supervise a complex savings association or holding company on a continuous basis. There is not a specific equation or trigger for this purpose. Rather, OTS bases this determination on the risk profile and resource needs of the institution or holding company enterprise.

Continuous supervision and examination combines on-site examination work, routine communication, and off-site planning, monitoring, and analysis into one ongoing examination process. The ongoing examination process includes developing planning documents; performing examination work; annually aggregating findings, recommendations, and corrective actions into a report of examination; and assigning examination ratings. Continuous supervision and examination comprises several key elements:

- Developing and Maintaining a Comprehensive Risk Assessment
- Preparing a Three-year Supervisory Plan
- Preparing an Annual Staffing Plan
- Scheduling and Conducting Targeted Reviews
- Coordinating with Other Regulators
- Instituting an Annual, Roll-up Examination Process and Reporting Framework
- Holding Routine Management Meetings and an Annual Board of Directors Meeting

Risk Assessment is fundamental for continuous supervision and examination. Examination staff is responsible for documenting the risk profile of an organization and cataloguing the systems and controls the organization enacts to manage and mitigate those risks. The risk assessment should include a clear summary of the operations of the consolidated organization in order to form a basis for the examination scope. It is a living document that the examination team will update as the organization evolves; however, the examiner-in-charge (EIC) should formally document, update, and finalize the risk assessment no less than annually.

The risk assessment should clearly identify risks from the insured depository, the holding company, and affiliates. It should also identify significant functionally regulated entities and non-regulated entities. The assessment considers all relevant sources of information including company-prepared risk assessments, examination findings, internal and external audit assessments and reports, reports from other depository institution and functional regulators, and financial and rating analyst reports. Staff consistency throughout the continuous examination process along with the documentation of a risk assessment of the organization will ensure a reliable basis for developing the three-year supervisory plan, the staffing plan, and scheduling components of examinations.

Supervisory Plans are examination maps that develop from risk assessments. They cover a three-year period. They address key examination areas including broad, organization-wide issues, and narrow, higher-risk, or discreet areas of review. The caseload manager will develop a supervisory plan in coordination with the EIC of the complex institution or holding company enterprise. The plan, which is subject to approval by senior management, defines the scope and timing of examination work and identifies resource needs. The supervisory plan is an active document that should incorporate significant examination findings and changes in risk profile. You should upload updated supervisory plans to the Electronic Continuing Examination File (ECEF) upon annual revision.

Each plan should be flexible to react to changes in the organization. The focus of the plan should be on the current examination year, but the document should include a summation of the proposed examination activities in subsequent years. By identifying and scheduling prospective examination areas for the current year and future years, OTS will be able to risk-focus our review. The supervisory plan enables us to logically proceed from one examination area to the next, building upon examination findings.

Each supervisory plan should also reflect the importance of the review of the insured depository. The supervisory plan and overall examination of a highly complex insured depository will require a more granular focus than for a complex holding company enterprise. In holding company examinations, the supervisory plan should outline how the examination team will coordinate with and incorporate the findings of the savings association examination.

Each complex organization subject to continuous supervision should have an annual ***Staffing Plan***. The staffing plan should develop as a product of the supervisory plan and should remain flexible to accommodate changes in risk profile, staff availability, and examination scope. The plan should project staffing needs for the upcoming year, including required examiner skill sets and the projected timing, duration, and location of specific assignments. The staffing plan must be complete for each organization by the end of July in order for senior management to consider it during OTS's annual resource allocation and staffing meetings. The risk assessment will also help OTS prioritize and assign examination resources.

Targeted Reviews examine and assess particular risk areas or activities of an organization. Examiners should use targeted reviews to support annual ratings assignments (CAMELS, CORE, MOECA, IT, CRA, and Compliance). EICs should incorporate a schedule for targeted reviews of these areas into the supervisory and staffing plans, explaining how they will meet the examination objectives.

Targeted reviews are conceptually similar to limited review examinations or field visits. Each targeted review should have a scope. Examiners should develop a customized PERK or notification letter for the institution, subsidiary, and/or affiliate's management. Examiners conduct examination work, hold interim and exit meetings with management, and prepare a targeted review report to document their findings. OTS incorporates material findings into the annual examination report and considers the findings when revising the risk assessment and supervisory plan. The examination team, in accordance with OTS examination procedures, establishes corrective actions and follow-up schedules when necessary.

Complex institutions often have multiple regulated entities. As part of continuous supervision, examiners and managers are responsible for ***Coordinating with Other Regulators***. For complex holding companies, the examination staff must identify all significant regulated entities within the corporate structure, including OTS-regulated savings associations. OTS examiners reviewing a subsidiary or affiliate of an organization that is subject to continuous supervision, should communicate with the complex organization's examination team to identify risks or material items that may affect the supervisory plan for the complex organization. Once the examination team identifies significant regulated entities, OTS staff should establish communication protocols, request examination reports, coordinate with and leverage off the work other regulators perform, and consolidate the material findings of other regulators into our overall examination conclusions.

Continuous supervision and examination incorporates an ***Annual Examination Process***. The process requires the EIC to compile and summarize the results of the risk assessment, supervisory planning, targeted reviews, and continuous monitoring and examination into an annual, roll-up examination report. The process is necessary to refresh information and to aggregate each area of review into one cohesive summary. The annual examination process should frame all elements of continuous supervision and should include the elements of OTS's current examination approach (i.e. review of CAMELS, CORE, MOECA, IT, CRA, and Compliance areas). It guarantees that OTS updates the organization's supervisory ratings to reflect organizational changes or findings when necessary.

The annual examination process should also include a method to follow-up, track, and monitor examination findings, corrective actions, and management's progress in addressing outstanding items. The tracking and monitoring system should correlate to the risk assessment and supervisory plan to ensure both documents reflect the organization's progress in correcting weaknesses. The EIC is responsible for tracking and ensuring the timely resolution of all examination issues.

Continuous supervision and examination includes formal ***Routine Management Meetings***. While the timing of the meetings should be flexible to accommodate supervisory needs, it is important to have established, formal interaction with senior management. These meetings should take place quarterly, at a minimum. The meetings are a bilateral forum to provide and receive information regarding the organization and examination. The organization should communicate operating results, changes in risk profile or strategic direction, steps taken to resolve material audit or examination deficiencies, etc. OTS should communicate changes to the supervisory plan, pertinent examination findings or corrective actions, proposed examination activities, etc. The formal quarterly meetings establish a routine dialogue between OTS and the organization that will support the continuous examination process.

Continuous supervision and examination also includes a formal ***Annual Board of Directors Meeting***. The board meeting should coincide with the issuance of the annual examination report. It is a forum for communicating ratings changes, material supervisory concerns, and for discussing the supervisory plan. It should also serve as the basis for soliciting board commitment for required corrective action. Meetings with the Audit or other appropriate board committee in lieu of the full board may be appropriate depending on case-by-case circumstances. The continuous examination approach emphasizes frequent, ongoing communications with the regulated organization.

Continuous supervision and examination provides staff continuity while allowing us to allocate and rotate resources effectively. It provides consistency in supervisory approach and greater flexibility for scheduling comprehensive, risk-based reviews of an organization's higher-risk areas. This program will ensure that our supervisory objectives are clear, we identify and align our staffing needs, and we regularly communicate with OTS-regulated complex organizations.

RISK MATRIX

OTS's objective is to examine a holding company enterprise in the areas that pose the greatest risk to the overall enterprise and the thrift subsidiary. This guidance outlines procedures for completing a risk matrix; an OTS-designed tool that enables supervisory staff to systematically assess the enterprise within a framework; identify areas within an enterprise where problems exist or are likely to emerge; prioritize areas to examine, review, and/or monitor; and when warranted, initiate timely corrective actions. The risk matrix is a key component of continuous supervision program for complex holding company enterprises.

Risk Focused Principles

The continuous supervision of complex holding company enterprises is risk-focused. Key elements of this approach are:

- Continuous monitoring and re-evaluation of the holding company enterprise's risk profile including updating the supervisory plan;
- Emphasis on assessing and monitoring the enterprise's management processes and core proficiencies for identifying, measuring, monitoring, and controlling risks inherent to its business;
- Greater leverage of management and board reports, internal audit reports, and external audit reports to supplement OTS's supervisory processes;
- Communication and coordination with foreign and functional supervisors; and
- Establishing a communication program with the enterprise to maintain a current understanding of risk levels, risk management programs, strategic initiatives, and material developments.

Risk Assessment

The examination team uses the risk matrix to develop a comprehensive, risk-focused profile of the holding company enterprise. The risk matrix is a structured format that identifies and summarizes an enterprise's significant business activities, the types and levels of inherent risks in those activities, and the adequacy of risk management over those activities.

The risk matrix is a tool that documents the risk assessment and helps guide the supervision process. It is not intended to impose an inflexible approach on the examination. Examiner judgment, current events, and resource availability may result in examination or review of areas that reflect lower risk before those that reflect higher risk. However, examination staff should consider what the matrices show, and ensure that all risks facing business units are factored in to the decisions.

The risk matrix can be developed for the consolidated organization, by legal entity, by business line, or by function. In developing the enterprise level matrix, examiners should use discretion in determining the detail and number of sub matrices necessary to document significant activities and the inherent risks.

The key components of the risk matrix are:

- Significant activities;

- Exposure;
- Level of inherent risks;
- Level of risk mitigation or quality of risk management;
- Composite or net risk;
- Direction of composite or net risk; and
- Supervisory sequence

Functional Tier Risk Matrix
[Enter Enterprise Name]

Activity	Exposure			Level of Inherent Risks														Risk Mitigation					Composite	Direction	Supervisory Sequence
	%	%	%	L = Low M=Medium H=High														1=Strong 2=Satisfactory 3=Fair or below					L = Low M=Medium H=High	1 = ↔ 5 = ↑ 6 = ↓	M = Monitor T = Target I = Immediate
	Percentage of Assets	Percentage of Revenue	Earnings at Risk	Credit/Asset	Market	Liquidity	Operational / Transaction	Legal/Regulatory	Reputation	Country/Sovereign	Systemic/Shock/Contagion	Concentration	Intra-group Transactions	Strategic and Execution	Insurance - reserving	Insurance - pricing/underwriting	Other	Governance	Policies/Procedures/Limits	Risk Monitoring / MIS	Internal Controls	Reinsurance			
Regulated Financial																									
Consumer																									
Commercial																									
Unregulated Financial																									
Consumer																									
Commercial																									
Treasury / Capital Markets																									

***Before you add comments, make sure the Auto-hide is turned on by following these steps:
Click on TOOLS -> OPTIONS -> VIEW (tab) and check the box titled "Comment Indicator Only"

***To add additional rows, insert the new row before the last to ensure conditional formatting is maintained. Otherwise, the conditional formatting within the table will not carry over to the newly added row.

Significant Activities and Exposure

Significant activities should include any significant business line, unit, and process. Examiners should identify significant activities using multiple sources including organization charts, strategic business plans, capital allocations, and internal/external financial reporting. You should use sound judgment to determine the significance or materiality of any activity in which a holding company enterprise engages. The following are examples of criteria that you may use:

- Assets generated by the activity in relation to total assets (on- and off-balance sheet);
- Risk-weighted assets generated by the activity in relation to total risk weighted assets;
- Revenue generated by the activity in relation to total revenue;
- Net income (before taxes) for the activity in relation to total net income (before tax);
- Risk-weighted capital for the activity in relation to total risk-weighted capital;
- Internal allocation of capital to the activity in relation to total capital;
- Insurance underwriting exposure in relation to capital; and
- Reserves allocated and held as a percentage of total reserves.

Inherent Risks

Risk is intrinsic to a business activity and arises from the exposure and its relationship to potential future events. You should evaluate inherent risk by considering the likelihood of the risk exposure to the adverse event or events and the resulting adverse impact on the holding company enterprise, financial and/or non-financial. With all types of risk, consideration should be given to how differences in foreign regulatory frameworks and market characteristics may mitigate or exacerbate firm-wide risk.

The CORE Holding Company Rating System identifies the following major types of risks:

Type of Risk	Description
Credit/Asset	Credit risk arises from the potential that a borrower or counterparty will fail to perform on an obligation. Asset risk is the risk related to market changes or performance of a financial asset.
Market	Market risk is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.
Liquidity	Liquidity risk is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (funding liquidity risk) or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (market liquidity risk).
Operational	Operational risk arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses. Transaction risk arises from problems with service or product delivery. This risk is a function of internal controls, information systems, employee integrity, and operating processes.
Legal / Compliance	Legal risk arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization. Compliance risk is the risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, or ethical standards.
Reputation	Reputation risk is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.
Country/ Sovereign	Country risk arises from the general level of political, financial, and economic uncertainty in a country, which affects the value of the country's bonds and equities. Sovereign risk is the risk that a central bank will impose foreign exchange regulations that will reduce or negate the value of foreign exchange contracts. It also refers to the risk of government default on a loan made to a country or guaranteed by it.
Contagion / Systemic	Contagion entails the risk that financial difficulties encountered by a business line or subsidiary of a holding company could have an adverse impact on the financial stability of the enterprise and possibly even on the markets in which the constituent parts operate. Systemic risk is defined by financial system instability, potentially catastrophic, caused or exacerbated by idiosyncratic events or conditions in financial intermediaries. Impacted areas include market value of positions, liquidity, credit-worthiness of counterparties and obligors, default rates, liquidations, risk premia, and valuation uncertainty.
Concentration	The exposure to losses due to a concentration (assets, liabilities, off-balance-sheet) at the subsidiary, business line, geographic, and/or enterprise level.

Intra-Group Transactions	Exposures to risk that result from transactions between affiliates.
Strategic And Execution	Strategic and execution risk is the risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities. Strategic risk focuses on more than an analysis of the written strategic plan. It focuses on how plans, systems, and implementation affect the enterprise's franchise value. It also incorporates how management analyzes external factors that affect the strategic direction of the company.
Pricing/ Underwriting Risk	Pricing and underwriting practices of the insurance entity are inadequate to provide for the risks assumed.
Reserving Risk	An insurance company's actual losses or other contractual payments reflected in reported reserves or other liabilities will be greater than estimated.

Level of Risk

After identifying significant activities, examiners should assess the level of inherent risk in those activities as low, moderate, or high. You should make this assessment without considering the impact of risk mitigation through the institution's risk management processes and controls. The matrix considers the quality of these factors separately and combines them with the inherent risk assessment to determine the net risk of each activity.

Level of Inherent Risk	
Low	Volume, size, or nature of activity poses immaterial or minimal impact, in the event of loss, on the holding company enterprise's condition.
Moderate	Volume, size, or nature of activity is average comprising traditional or typical risks. Loss exposures could be absorbed in the normal course of business.
High	Volume, size, or nature of activity could result in significant and harmful loss.

Risk Mitigation - Adequacy of Risk Management

You should evaluate the adequacy of risk management for each significant activity in relation to the following key elements of a sound risk management system:

Elements of Risk Management Systems	
Governance / Board and Senior Management Oversight	A review of this area evaluates the adequacy and effectiveness of board and senior management's understanding and management of risk inherent in the holding company enterprise's activities, as well as the general capabilities of management. It also considers management's ability to identify, understand, and control the risks within the holding company enterprise, to hire competent staff, to manage cross-border and cross-cultural variables, and to respond to changes in risk profile or industry innovations.
Policies, Procedures, and Limits	A review of this area evaluates the adequacy of policies, procedures, and limits given the risks inherent in the activities of the consolidated enterprise and its stated goals and objectives. Your analysis should consider the adequacy of the enterprise's accounting and risk disclosure policies and procedures.
Risk Monitoring and Management Information Systems	A review of this area assesses the adequacy of risk measurement and monitoring, and the adequacy of its management reports and information systems. Your analysis should include a review of the assumptions, data, and procedures used to measure risk and the consistency of these tools with the level of complexity of the enterprise's activities.
Internal Controls	A review of this area evaluates the adequacy of internal controls and internal audit procedures, including the accuracy of financial reporting and disclosure and the strength and influence, within the enterprise, of the internal audit team. Your analysis should include a review of the independence of control areas from management, the consistency of internal audit procedures across geographic lines, and the appropriateness of the scope coverage of the internal audit team for the complexity of the enterprise.

Considering these key elements, examiners should assess the relative strength of the risk management processes and controls for each identified function or activity. For the risk assessment, you should characterize the relative strength as Strong (1), Satisfactory (2), or Fair (3).

These definitions are identical to the Risk Management component rating of CORE. You should primarily use the risk matrix for risk assessment and supervisory planning. Consequently, anything worse than a Fair risk management rating (4 or 5) is not necessary since a Fair rating in this area would prompt a high level of response. However, the adequacy of risk management serves as a starting point for assessing the relative strength or weakness of the holding company enterprise's risk mitigation and the overall risk management rating of the enterprise.

Adequacy of Risk Management Definitions		
1	**Strong risk management**	Management effectively identifies and controls all major enterprise risks. Management is fully prepared to address risks emanating from new products and changing market conditions. The board and management are forward-looking and active participants in managing risk. Management ensures that appropriate policies and limits exist and that the board understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide management and the board with the information and analysis necessary to make timely and appropriate decisions in response to changing conditions. Risk management practices and the enterprise's infrastructure are flexible and highly responsive to changing industry practices and current regulatory guidance. Staff has sufficient expertise and depth to manage the risks assumed. Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the holding company. There are few noted exceptions to the enterprise's established policies and procedures, and none is material. Management effectively and accurately monitors the condition of the enterprise consistent with applicable laws, regulations, and guidance, and in accordance with internal policies and procedures. Risk management processes are fully effective in identifying, monitoring, and controlling risks.
2	**Satisfactory risk management**	The enterprise's management of risk is largely effective, but exhibits some minor weaknesses. Management and the board demonstrate a responsiveness and ability to cope successfully with existing and foreseeable risks in the business plans. While the enterprise may have some minor risk management weaknesses, management and the board have recognized and are resolving these problems. Overall, board and senior management oversight, policies and limits, risk monitoring procedures, reports, and management information systems are satisfactory and effective. Risks are controlled and do not require additional supervisory attention. The holding company enterprise's risk management practices and infrastructure are satisfactory, and management makes appropriate adjustments in response to changing industry practices and current regulatory guidance. Staff expertise and depth are generally appropriate to manage the risks assumed. Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the condition of the enterprise.
3	**Fair risk management**	There are moderate deficiencies in risk management practices and, therefore, there is cause for additional supervisory attention. One or more of the four elements of sound risk management is not acceptable, which precludes the enterprise from fully addressing one or more significant risks to its operations. Certain risk management practices need improvement to ensure that management and the board are able to identify, monitor, and control all significant risks. In addition, the risk management structure may need improvement in areas of significant business activity, or staff expertise may not be commensurate with the scope and complexity of business activities. Management's response to changing industry practices and regulatory guidance may not be sufficient. The internal control system may be lacking in some important aspects, leading to continued control exceptions and a failure to adhere to written policies and procedures. The risk management weaknesses could have adverse effects if management does not take corrective action.

The following grid provides guidance on assessing the composite risk of an activity by balancing the observed quantity and degree of risk with the perceived strength of related management processes and internal controls. The composite risk in these activities is the aggregate inherent risk offset by the aggregate quality of risk management.

Inherent Risks ***mitigated by*** Adequacy of Risk Management = Composite (Net) Risk

Composite Risk Assessment			
Risk Mitigation	**INHERENT RISK OF THE ACTIVITY**		
	Low	**Moderate**	**High**
Weak	Low or Moderate	Moderate or High	High
Acceptable	Low	Moderate	High
Strong	Low	Low or Moderate	Moderate or High

Composite Risk Definitions

You determine the composite risk for each significant activity by balancing the overall inherent risk of the activity with the overall strength of risk management systems for that activity arriving at net risk.

For example, you may evaluate the investment banking activity of an entity as having a high aggregate level of inherent risk arising from a combination of high credit risk, high market risk, and high liquidity risk. However, you may rate the net risk for the activity as moderate due to mitigation by a strong aggregate quality of risk management resulting from strong operational management, strong internal audit, strong risk management, and strong directorate oversight.

Another example would be commercial real estate loans, which are usually higher risk. However, the institution may reduce the probability and magnitude of possible loss by having conservative underwriting standards, effective credit administration, strong internal loan review, and a good early warning system. Consequently, after accounting for these mitigating factors, the overall risk profile and level of supervisory concern associated with commercial real estate loans may be moderate.

The following grid provides guidance on assessing the composite risk of an activity by balancing the observed quantity and degree of risk with the perceived strength of related risk management processes and mitigants.

Composite Risk Definitions	
Low	You should assign low composite risk to an activity, function, or product that has low inherent risks. You may also assess a low composite risk for an activity with moderate inherent risk when internal controls and risk management systems are strong and effectively mitigate much of the risk.
Moderate	You should assign moderate composite risk to an activity, function, or product with moderate inherent risk where the risk management systems appropriately mitigate the risk. For an activity with low inherent risk, significant weaknesses in the risk management system may result in a moderate composite risk assessment. Concurrently, a strong risk management system may reduce the risks of an inherently high-risk activity so that any potential (financial*)* loss from the activity would have only a moderate negative impact on the financial condition of the organization.
High	You should assign high composite risk to an activity, function, or product when the risk management system does not significantly mitigate the high inherent risk of the activity. Thus, the activity could potentially result in a (financial) loss that would have a significant negative impact on the enterprise.

Direction

In arriving at net risk through the composite exercise, it is important to determine the current direction of composite risk. You may assess the direction of risk as decreasing, stable, or increasing over an appropriate time horizon for the institution. This indicates risk movement and not changes in the composite rating. In determining the appropriate time horizon for each holding company enterprise, examiners should consider the enterprise's business activities, markets, and strategic plans.

Direction of Risk Definitions	
↓	Decreasing direction indicates the examiner anticipates based on current information that the composite risk will decline over the next 12 months.
↔	Stable direction indicates the examiner anticipates that composite risk will remain unchanged.
↑	Increasing direction indicates the examiner anticipates that composite risk will be higher 12 months in the future.

Supervisory Sequence Gauge (SSG)

The SSG provides a general framework to prioritize examination activities according to the level and direction of net risk. The matrices and risk assessments are tools that reflect risk and help guide the examination and supervision process. They should not impose an inflexible approach to examination work. Judgment, current events, and resource availability may lead to examinations or reviews of units that the matrices show to be of lower risk before other units that reflect higher risk. However, examiners should make those decisions in consideration of what the matrices show, ensuring that they factor the risks facing business units into the decisions.

Supervisory Sequence Gauge			
	DIRECTION		
RISK PROFILE (weighted)	Decreasing ↓	Stable ↔	Increasing ↑
Low	Low/ ↓ Monitor 1	Low/ ↔ Monitor 1	Low/ ↑ Target 1
Moderate	Moderate/ ↓ Monitor 2	Moderate/ ↔ Target 1	Moderate/ ↑ Target 2
High	High/ ↓ Target 1	High/ ↔ Target 2	High/ ↑ Immediate

Matrix Ranking	Supervisory Response
Monitor 1	Lowest priority - annual/high level monitoring annual
Monitor 2	Low priority - quarterly or annual monitoring / extended target review cycle
Target 1	Medium priority - regularly scheduled targeted review
Target 2	High priority - targeted review scheduled for next cycle / monitored quarterly
Immediate	Highest priority - targeted review scheduled within current cycle / monitoring

Supervisory Plan

The supervisory plan should outline the examination team's supervisory approach, focus on the risk areas the risk matrix identifies, and develop a framework for examining and monitoring those risks.

The supervisory plan merges the results of the risk assessment with the supervisory activities necessary to oversee those risks. It is a high level document that describes the holding company enterprise's operational structure, outlines OTS's supervisory approach, and tracks examination activities and the activities of functional or foreign supervisors. Each developed plan, with attendant supervisory activities (CORE reviews, targeted reviews, off-site monitoring, communications), should be robust and should include a current and thorough view of the holding company enterprise's risk and operational profile including risk management systems. Furthermore, the consolidated view of the holding company enterprise should include applicable supervisory strategies for reviewing information technology, compliance, the federal savings bank, material financial services activities (i.e. banking, insurance, asset management, securitizations, etc.), and other key operations of the complex holding company enterprise.

PROCEDURES

The examination team should annually develop the supervisory plan. The supervisory plan should be an active document that receives updates as material events, significant acquisitions or dispositions, and changes in corporate strategy occur. The examination team should ensure that the plan is current and relevant to the holding company enterprise's risk profile. The plan should address how the examination team will review and monitor key risk areas based on the results of the risk assessment or from identified concerns in the prior roll-up examination or recent targeted reviews.

A supervisory plan should include the following key elements:

- Risk profile of the holding company enterprise;
- Supervisory strategic goals;
- Examination objectives;
- Three-year planning;
- Communication; and
- Foreign and domestic relations.

Risk Profile

A supervisory plan should summarize the risk profile of the holding company enterprise. The goal of the risk profile summary is to express a holistic, risk-focused view of the enterprise and to focus the examination on key risk areas. The profile should:

- Compile the results of the risk assessment including identifying the composite or net risk of the holding company enterprise;
- Describe the enterprise's inherent risks and the direction of the risks;
- Identify the significant activities (major functions, business lines, products, or legal entities) that could affect the risk profile;
- Relate composite risk positions and directions to the holding company enterprise's risk management system;
- Identify the strengths and weaknesses of internal or external audit;
- Describe the ability of the holding company enterprise to manage risk prospectively.

Supervisory Strategic Goals

The supervisory plan should outline the strategic goals of supervision for the examination cycle. This section should describe the examination team's proposed activities to monitor and examine the risk profile of the holding company enterprise during a one-year time horizon. This section is flexible and should also include improvements to administrative processes that facilitate the examination. Examples of strategic goals include:

- Enhancing knowledge of risk management systems or lines of business;
- Improving communication with specific committees or managers in the enterprise;
- Implementing systems to achieve greater resource efficiency;
- Enhancing compliance with objectives and policy guidance;
- Developing strategic relationships with other supervisors.

Examination Objectives

You should formulate examination objectives to achieve the supervisory strategic goals and to prepare the examination team to rate the CORE elements for the corresponding supervisory cycle. You should outline the examination program and provide a comprehensive listing of examination activities including targeted reviews, monitoring activities, CORE analysis, etc.

Objectives should include:

- A discussion of the objectives for the current supervisory cycle.
- An identification of the ongoing holding company enterprise supervisory activities and the targeted reviews recommended for the cycle;
- A brief description of the procedures the examination team will perform including whether sampling is indicated or not;
- A description of the level of reliance and coordination with internal risk management systems, internal audit, and external audit;
- A discussion of how findings of the targeted reviews will factor into the CORE roll-up;
- A discussion on the reliance and coordination with other functional or foreign supervisors.

Three-year Planning

You should develop a broad, three-year, supervisory plan to document recommendations for future reviews of key risk areas that the examination team will not perform during the current examination cycle. The primary focus of the supervisory plan should remain on the current examination year. However, it is important to identify key risk areas you will not review during the current examination cycle and to identify how you will prioritize them. The three-year planning portion of the supervisory plan will be a dynamic map of activities that should evolve with changes in the risk assessment, the enterprise's operations, and examination findings. The three-year planning process should also contribute to the continuity of the examination

Communication

The supervisory plan should identify meeting schedules and other communications with key parties in the holding company enterprise. It should identify and list key management contacts. The communication plan should outline coordination with other functional and relevant supervisors, identify central points of contact, and address exit/annual meetings according to OTS policy. Examples of regularly scheduled meetings include:

- Quarterly updates (risk management, internal audit, compliance, etc.)
- Entry and exit meetings for targeted reviews
- Annual roll-up meeting with the board of directors
- Follow-up meetings to discuss outstanding issues/remediation
- Routine meetings with senior management and business leaders

Foreign and Domestic Relations

The supervisory plan should identify key foreign and functional regulators with which the examination team plans to coordinate during the examination cycle. It should identify plans for joint examinations, supervisors meetings, and sharing examination findings, when applicable. This section should also identify plans for communication with foreign or functional supervisors, including meeting schedules, planned correspondence, and key contacts.

Targeted Reviews

Each targeted review should focus on one significant activity, process, legal entity, or product/business line. To conduct a targeted review, you should follow the same administrative process you perform for full scope examinations. Specifically, you should:

- Review available pre-examination materials.
- Develop a scope document.
- Develop a work program.
- Develop a customized Preliminary Examination Response Kit (PERK).

- Schedule and conduct an opening meeting.
- Develop and upload work papers to support conclusions.
- Prepare and upload a targeted review report to document your findings.
- Hold interim and exit meetings with management.

Targeted reviews are conceptually similar to limited review examinations. Before commencing a targeted review, you should open a Type 93 examination (Holding Company Limited) in EDS/ROE. As with a regular examination, examiners should allocate all hours and travel expenses dedicated to a targeted review to the applicable docket number and examination through the WebTA and Travel Expense Report Filing (TERF) systems.

Throughout the stages of the targeted review, you should maintain open communications with OTS staff involved in the supervision of the holding company enterprise. This is particularly important in developing the PERK and scope document. You should avoid making duplicative information requests. If you are conducting a targeted review that affects the thrift subsidiary, you should communicate with the individual(s) responsible for supervising the thrift institution (i.e. regional field and caseload managers). You should also invite these individuals to opening briefings and other meetings, including the exit conference. It is essential that you communicate all material findings and corrective actions to management before you communicate them to holding company management.

The following sections provide guidance on each step of the targeted review.

Documenting the Scope of a Targeted Review

Targeted reviews require a written scope document. In the scope, you should identify the specific areas for review and outline the objectives you want to achieve in conducting the review. You should include the final scope document in the work papers you upload to the EDS/ROE at the conclusion of the targeted review.

Before commencing a targeted review, you should consult with OTS staff involved in monitoring or supervising the firm or affiliates of the firm. The scope should consider information from the prior examination and reviews of other pertinent documents. The scope document should:

- Identify the target of the review (business line, legal entity, product, activity, or process).
- Discuss the risk characteristics of the business line, legal entity, product, activity, or process (including inherent risks and risk management practices).
- Discuss why the review is necessary (i.e. high risk, new product/activity, high growth, strategic importance, identified deficiencies).
- Identify the review objective. The fundamental review objective in most cases is to verify that the firm's risk management processes function according to management's representations. It is

important that you understand how the enterprise manages the business line or subsidiary within the holding company structure. Through the targeted review, you should gain a clear understanding of the operation to assess the reliability of the risk management processes.

- Outline the review methodology and program steps.

- Identify review logistics (location, staffing, and timeframes).

DEVELOPING A WORK PROGRAM

You should develop a work program that describes specific procedures/activities that the examination team will perform during the targeted review. In developing the work program, you should review relevant risk focused procedures/programs in OTS Handbooks and other guidance. If you intend to conduct sampling or transaction testing, describe your objectives. Also, describe how you will leverage off work performed by internal audit, external audit, or other functional regulators.

You should develop program steps to fulfill your targeted review objectives and to ensure you can support your conclusions. Some key areas you should include in the program steps include reviewing:

- Board and senior management oversight.

- The adequacy of key policies, procedures, controls, and exposure limits.

- Risk management practices, including monitoring procedures and reporting procedures (Are reports provided to management timely, accurate, and appropriately detailed to allow management to fulfill its oversight responsibilities?).

- Internal audit coverage.

Uniform work programs and procedures are not possible for every targeted review. In many circumstances, you will have to develop specific procedures that target a particular risk area. In situations where there are no clear procedures or reference points, you should work with other relevant subject matter experts to develop appropriate review procedures.

Developing the PERK

You should develop a customized PERK or notification letter for the managers of the targeted review area. You should coordinate with appropriate office staff to develop a PERK for items you will need from the firm to complete the review. You should only request items that are not publicly available and that the firm has not already provided during the normal monitoring process. You should not request reports from other functional regulators through the company unless the functional supervisor has already agreed to such an arrangement. Ensure the PERK includes target dates for delivery of the requested materials.

OPENING MEETING

When you submit the PERK to the firm, you should schedule an opening meeting. Schedule the meeting to allow the examination team sufficient time to receive and review the PERK information. Attendees at the opening meeting should include appropriate firm/business line and risk managers, relevant members of the onsite team, appropriate subject matter experts, and representatives from senior management as appropriate.

Use the meeting to confirm, modify, or supplement your understanding of the business line, legal entity, product, or process, and to pose questions from your review of the PERK. The opening meeting should provide you with information to narrow and refine the scope of the targeted review. You should develop an agenda or summary memo of the opening meeting to include in the work papers that you upload to the EDS/ROE at the conclusion of the targeted review.

As necessary, you should schedule follow up meetings, request additional information for clarification, or request additional materials critical to the review.

Conducting the Targeted Review

Implement the work program. As work progresses, you should modify the work program or the scope of the review based on your findings. It is important that you maintain ongoing communication with regional management and other subject matter experts.

Work Papers

You must document the work you perform during the targeted review. The work papers must support the conclusions you reach and should include:

- The scope document
- The work program and procedures
- The PERK request
- Policies, procedures, schedules, or reports that contribute to your conclusions
- Summaries of meetings

Before concluding the targeted review, upload all work papers to EDS/ROE and remove them from the shared N:\ drive folder.

Holding Interim and Exit Meetings with Management

Section 070 of the Examination Handbook contains guidance on conducting meetings with management. At a minimum, you should conduct an exit conference at the conclusion of the targeted review. You should also hold interim meetings with management when necessary. You should base the list of attendees on the nature and seriousness of the findings and recommendations in the report. If the findings and recommendations are routine, attendees should include the business line/product/function manager, the lead examiner of the targeted review, the examiner in charge, and other appropriate OTS staff. If there are material findings, you should include a senior representative from internal audit, appropriate senior/executive holding company managers for the firm, and a representative from OTS senior management.

You should provide a final copy of the targeted review report to the firm at the exit meeting.

HOLDING COMPANY REPORT OF EXAMINATION

entity name
Street address
City state
Structure Number:

OTS Supervisory Office:

Type of Examination:

Examination Start Date:
Examination Completion Date:

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, auditor, independent auditor, subsidiary institution, or affiliated holding company.

If the holding company receives a subpoena or other legal process calling for production of this document, notify the appropriate Supervisory Office immediately. Advise the attorney and, if necessary, the court of the above prohibition and refer them to 12 C.F.R. Section 510.5.

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Holding Company Examination

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Holding Company Structure

Name and Address of Holding Companies	H Number

Thrift Subsidiaries (Name, City, State)	Region	Docket No.

Other Affiliates Reviewed

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

entity name
street address
city state

Members of the Board or their Representative:

Pursuant to Section 10 of the Home Owners' Loan Act, we performed a risk-focused examination of the holding company enterprise that controls ____________. The thrift holding companies and other significant affiliates reviewed as part of this examination are listed on the Holding Company Structure page of this report. The examination began on August 18, 1989.

The comments that follow summarize conditions, policies, practices, and trends that affect the risk level of the holding company enterprise. 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 timely corrective action.

Information, comments and conclusions contained in this report are based on filings made with the Office of Thrift Supervision or other financial regulators, and the books and records of entities in the holding company enterprise. OTS prepared this report for supervisory purposes, and you should not consider it an audit report.

Please review the report in its entirety at your next meeting and note your review in the minutes of that meeting. You need not prepare or send OTS a written response to the report.

Please review the report in its entirety at your next meeting, adopt any corrective actions called for, and note your review and actions in the minutes of that meeting. You need not prepare or send OTS a written response to the report.

Please review the report in its entirety at your next meeting. Please send us a certified copy of excerpts from your minutes stating that you reviewed the report. Also please advise us of what action you took, or will take, regarding each point discussed in the Matters Requiring Board Attention section of this report. In order to expedite the processing of the report, please reply within ____ days from the date of this letter.

If you have any questions, please call me at______________. If I am unavailable, please call __________, at ____________.

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Office of Thrift Supervision
Holding Company Examination

Examination Date:
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Signatures of Directors

We, the undersigned directors of entity name or their representatives, have personally reviewed the contents of this report of examination.

Signature	**Date**

Note: This form may remain attached to the report of examination and be retained in the holding company's file for review during subsequent examinations or may be sent to the OTS Supervisory Office.

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Office of Thrift Supervision
Holding Company Examination

Examination Date:
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Table of Contents

Office of Thrift Supervision
Holding Company Examination

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Examination Conclusions and Comments

	Current Examination 08/18/1989	Previous Examinations [a]	
Composite Holding Company Rating			
Component Ratings:			
Capital			
Organizational Structure			
Risk Management			
Earnings/Liquidity			

	Current Category	Prior Category
Holding Company Risk/Complexity Category		

/s/
Examiner-in-Charge

[a] For holding company examinations commencing before January 1, 2008, OTS assigned one of the following composite ratings: A – Above Average, S – Satisfactory or U – Unsatisfactory.

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Matters Requiring Board Attention

The examiner's review disclosed no matters requiring a written response from the board of directors; however, the board is responsible for the adoption and implementation of any corrective actions called for in other sections of this report.

The examiner's review disclosed the following matters that the board should specifically address in their written response to this examination report. The board is also responsible for the adoption and implementation of any corrective actions called for in other sections of this report.

Due Date	**Required Response**
	•
	•
	•
	•
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	•
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	•

Office of Thrift Supervision
Holding Company Examination

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Examiner Findings

Major Areas of Review

Capital

The Capital component reflects the adequacy of an enterprise's consolidated capital position, from a regulatory perspective and an economic capital perspective, as appropriate to the holding company enterprise. Capital adequacy is evaluated in terms of the risk inherent in an enterprise's activities and the ability of capital to absorb unanticipated losses, support business activities including the level and composition of the parent company and subsidiaries' debt, and support business plans and strategies.

Organizational Structure

The Organizational Structure component assesses the operations and risks in the holding company enterprise. Organizational structure is evaluated in relation to lines of business, affiliate relationships, concentrations, exposures, and the overall risk inherent in the structure.

Risk Management

The Risk Management component assesses board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems; and internal controls. These areas are evaluated in the context of inherent risks as related to the size and complexity of the holding company's operations.

Earnings/Liquidity

The Earnings component reflects the consolidated holding company enterprise's overall financial performance, including measures such as the quality of consolidated earnings, profitability, and liquidity. Earnings is evaluated in terms of the level, trend, and sources of earnings on a consolidated level, as well as for material legal entities or business lines, and in terms of the ability of earnings to augment capital and to provide ongoing support for an enterprise's activities.

This component also assesses the liquidity of the holding company enterprise, including the ability to attract and maintain the sources of funds necessary to achieve financial efficiency, support operations, and meet obligations.

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Compliance With Enforcement Actions

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Directors, Senior Executive Officers, and Attorneys

Number of Directors Meetings Held During Past 12 Months:
Number of Directors Authorized:
Number of Vacancies:

Name Occupation	Title Year Appt.	No. of Shares Under Option	No. of Shares Owned	Percent of Total Outstanding

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Summary of Holding Company Stock Ownership

Stock Ownership	No. of Shares Under Option	No. of Shares Owned	Percent of Total Outstanding
Affiliated Entities (including employee stock ownership plans)			
Total			
Others Owning 5% or More of Outstanding Shares			
Total			

Total Shares Authorized:

Total Shares Outstanding:

Par Value: $

Market Value (as of____________): $

Office of Thrift Supervision
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Statements of Financial Condition

Statement of Financial Condition (000s)	Current Year-to-Date mm/dd/yyyy	Most Recent Fiscal Year Ended mm/dd/yyyy	Prior Fiscal Year Ended mm/dd/yyyy
Assets	$	$	$
Total Assets			
Liabilities and Net Worth	$	$	$
Total Liabilities and Net Worth			

Office of Thrift Supervision
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Statements of Operations

Comparative Statement of Operations (000s)	Current Year-to-Date mm/dd/yyyy	Most Recent Fiscal Year Ended mm/dd/yyyy	Prior Fiscal Year Ended mm/dd/yyyy
Income	$	$	$
Total Income			
Expenses	$	$	$
Total Expenses			
Net Income			

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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:	$	$	$	$
Additions:				
Total Additions	$	$	$	$
Deductions:	$	$	$	$
Total Deductions	$	$	$	$
Balance at Close of Fiscal Year:	$	$	$	$

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Outstanding Debt

Outstanding or Committed Debt			
Date of Borrowing:		**Maturity Date:**	
Name of Lender:		**Original Amount:**	
Amount Outstanding:		**Interest Rate:**	
Rating:		**Rating Agency:**	
Type of Debt:			
Purpose:			
Other Terms:			
Covenants or Restrictions:			

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Outstanding Hybrid Securities

Outstanding Hybrid Securities			
Date of Issuance:		**Maturity Date:**	
Public Offering or Private Placement:			
Amount of Issuance:		**Callable Date:**	
Rating:		**Rating Agency:**	
Rating:		**Rating Agency:**	
Type of Security:			
Purpose:			
Other Terms:			
Covenants or Restrictions:			

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Cash Analysis

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

Office of Thrift Supervision
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Cash Analysis (continued)

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

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Risk Concentrations

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Significant Intra-Group Transactions

Transaction Description and Date	Affiliate Paying or Guaranteeing Funds	Affiliate Receiving Funds or Guarantee

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Other Subsidiaries' Consolidated or Unconsolidated Statements

Statement of Financial Condition [Name of Subsidiary] (000s)	**Fiscal Year Ended mm/dd/yyyy**	**Fiscal Year Ended mm/dd/yyyy**	**Fiscal Year Ended mm/dd/yyyy**
Assets			
	$	$	$
Total Assets			
Liabilities and Net Worth			
	$	$	$
Total Liabilities and Net Worth			

Office of Thrift Supervision
Holding Company Examination

Examination Date:
S- Number:

Other Subsidiaries' Consolidated or Unconsolidated Statements (continued)

Statement of Operations [Name of Subsidiary] (000s)	**Fiscal Year Ended mm/dd/yyyy**	**Fiscal Year Ended mm/dd/yyyy**	**Fiscal Year Ended mm/dd/yyyy**
Income	$	$	$
Total Income			
Expenses	$	$	$
Total Expenses			
Net Income			

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Miscellaneous

Office of Thrift Supervision
Holding Company Examination

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Appendix Pages

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Holding Company Definitions

Holding Company Rating Definitions

Upon completion of the examination, the holding company enterprise is rated by the OTS. The holding company rating reflects the overall condition of the holding company enterprise.

The five holding company ratings are defined as follows:

Composite 1. A holding company enterprise in this group is sound in almost every respect and generally has components rated 1 or 2. Any weaknesses are minor, and the board of directors and management can correct them in the normal course of business. The enterprise is able to withstand economic, financial, and risk exposure changes because of an effective organizational structure, solid risk management practices, more than sufficient capital and strong earnings. Cash flow is more than sufficient and adequately services debt and other obligations. This holding company enterprise exhibits strong performance and risk management practices relative to its size, complexity, and risk profile.

Composite 2. A holding company enterprise in this group is fundamentally sound but may have modest weaknesses. The board of directors and management are capable and willing to correct any weaknesses. Generally, no component rating should be more severe than 3 for this holding company enterprise. The organizational structure, risk management practices, capital and earnings create stability, and this holding company enterprise is capable of withstanding business fluctuations. Cash flow is adequate to service obligations. Overall, risk management practices are satisfactory relative to the enterprise's size, complexity, and risk profile.

Composite 3. A holding company enterprise in this group raises some degree of supervisory concern in one or more of the component areas, with weaknesses that range from moderate to severe. The magnitude of the deficiencies is generally not severe enough to rate a component more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. The holding company enterprise's capital structure and earnings leave it less resistant to adverse business conditions. The effectiveness of the organizational structure and risk management practices may be less than satisfactory relative to the enterprise's size, complexity, and risk profile. However, there is only a remote threat to the holding company enterprise's continued viability.

Composite 4. A holding company enterprise in this group has serious financial or managerial deficiencies that result in unsatisfactory performance. The supervisory concerns, which management and the board are not satisfactorily addressing, range from severe to critically deficient. A holding company enterprise in this group generally does not have sufficient capital and earnings to withstand adverse business fluctuations. The effectiveness of the organizational structure and risk management practices are generally unacceptable relative to the enterprise's size, complexity, and risk profile. The enterprise may place undue pressure on subsidiaries to meet its cash flow by upstreaming imprudent dividends or fees. Unless there is prompt action to correct these conditions, future viability could be impaired.

Composite 5. The magnitude and character of the risk management or financial weaknesses of a holding company enterprise in this category could lead to insolvency without immediate aid from shareholders or supervisory action. The volume and severity of problems are beyond the board and management's ability or willingness to control or correct. The effectiveness of the organizational structure and risk management practices are inadequate relative to the enterprise's size, complexity, and risk profile. The inability to prevent liquidity or capital depletion places the holding company enterprise's continued viability in serious doubt.

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Holding Company Definitions (continued)

Holding Company Risk/Complexity Category Definitions

The three holding company risk/complexity categories are defined as follows:

Category I

This category holding company is viewed as noncomplex and having relatively low risk.

Category II

This category holding company is considered to have a complex structure and/or a higher risk.

Category III

This category holding company is one of the most complex or highest risk holding companies. It is made up of a number of different companies or legal enterprises that offer products from more than one financial sector.

Introduction

Capital serves many purposes, and the level and composition of capital a company holds is an important measure of its overall financial health, as well as the health of its subsidiaries. Holding companies must ensure that they have sufficient capital to support their underlying risks. Capital provides a holding company with a buffer in times of poor operating performance, maintains public confidence in the holding company, and supports growth. Raising capital for the enterprise often takes place at the holding company level. An efficient capital structure is one that combines the appropriate mix of equity and debt to fund an enterprise's strategic plan and enhance financial performance without unduly burdening subsidiaries, particularly the thrift. Hybrid instruments add one more option to the capital funding mix. A hybrid instrument is generally a security that has both equity and debt characteristics.[1]

LINKS

Appendix A

The scope and complexity of banking and other financial services, particularly the array of financial products, makes it important to evaluate capital based on a company's overall risk profile. High capital ratios alone do not indicate capital adequacy, especially when an organization is involved in risky activities or capital arbitrage techniques. Organizations use internal processes to assess risks and to ensure that capital, liquidity, and other financial resources are sufficient in relation to their risk profile. The sophistication and level of detail of a holding company's capital management techniques varies based on the complexity and size of the enterprise. You should request the holding company's support and analysis for its capital management strategies in the pre-examination response kit or during the course of the examination.

OTS-regulated holding companies should have a prudential level of capital to support their risk profile.

OTS-regulated holding companies should have a prudential level of capital to support their risk profile. OTS does not impose consolidated or unconsolidated regulatory capital requirements on thrift holding companies. As a result, examiners must consider all aspects of an organization's risk profile to determine if capital is adequate on a case-by-case basis. In the capital component you will review:

- The level of debt/hybrid instruments and the ability of the holding company to service its obligations.
- The quality and quantity of capital using several different measures as well as the availability of capital and the ability of the holding company to raise new capital if needed.
- The holding company's dividend practices.

[1] Appendix A provides an overview of hybrid capital instruments.

Capital Sufficiency/Risk Analysis

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. The examination team then refines and updates this preliminary risk assessment as its understanding of the holding company evolves during the examination. Many of the conclusions that you will make in addressing the capital strength of a holding company will be dependent on findings in other examination components. For example, the following questions help 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 to properly address them:

Organizational Structure Issues

- What is the nature and level of risk associated with the holding company's activities?
- Is the volume or term of intra-group transactions cause for regulatory concern?
- Are levels of exposures or concentrations acceptable?

Risk Management Issues

- Does management effectively identify and control major risks?
- Are internal controls and audit procedures reliable?
- Are board and senior management oversight, policies and limits, risk monitoring procedures, reports and management information systems effective?

Earnings Issues

- Is the overall financial condition of the holding company deteriorating, stable, or improving?
- Does the holding company have sufficient earnings to support dividends?

Other Capital Related Issues

- Do the holding company and 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 the balance sheet?
- Are there any terms, conditions, or covenants in the holding company's or other affiliate's securitization documents or securities prospectuses that could trigger early amortization, the transfer of servicing, or other events?

- How does the holding company capital level compare to its peers?

- How do ratings and other industry analysts perceive the holding company?

- Has the holding company issued equity securities with terms that could adversely affect its ability to raise capital by issuing additional shares?

EVALUATING DEBT AND HYBRID INSTRUMENTS

Financial leverage is the use of debt to supplement the equity in a company's capital and funding structure. Debt includes borrowings with specific terms and excludes deposits and transactional liabilities. To analyze the holding company's overall use of leverage, you should also include trust preferred securities or similar hybrid instruments that possess both debt and equity characteristics.

From the perspective of management and stockholders, debt/hybrid instruments can represent a favorable financial tool as the owners only need to provide a small portion of the total financing, and the lenders will bear much of the financial risk. 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/hybrid instruments 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 obligations resulting in greater risk taking.

- Highly leveraged firms are more susceptible to losses during economic downturns in the general economy or in specific industries. These losses compound because declining financial condition increases borrowing costs. As debt or hybrid securities mature, the company must renew them, often at higher interest rates.

- The use of leverage reduces management's flexibility in making future decisions; lenders may impose the following types of covenants that could adversely affect the thrift:

  - Limits on future issues;

  - Provisions to accelerate repayment in certain circumstances;

  - Limits on dividend payments; or

  - Specific constraints on operating ratios.

You must assess the role of leverage within the consolidated holding company operations/financial structure. You should also assess the actual and potential affect such leverage may have on its operations, or on the operations of the thrift. Implicit in such analysis, you need to identify the extent the holding company utilizes debt or hybrid instruments to capitalize/fund the thrift's operations, and the degree to which the parent relies upon the thrift to provide cash flow to service obligations resulting from debt or hybrid issuances.

Holding company boards of directors should develop prudent capital management plans before undertaking financing activities in the marketplace. Otherwise, they may be implementing a funding strategy that creates financial burdens. You should review the way the holding company deploys the proceeds of such financings and services such obligations. You will also need to determine if the holding company is overextended given its financial characteristics.

Holding company boards of directors should develop prudent capital management plans before undertaking financing activities in the marketplace.

You should consider the following questions:

- What is the ratio of holding company debt as a percentage of tangible capital?[2]
- What is the ratio of holding company hybrid instruments as a percentage of tangible capital?
- Is the level of debt/hybrid instruments rising?
- What investments or activities do the debt/hybrid instruments fund?
- What effect could the terms, conditions, or covenants have?
- What is the maturity schedule for debt or hybrid instruments' effect on liquidity?
- What is the level of interest expense?
- Is interest expense a significant percentage of recurring income?
- What is the primary source of funds to pay interest or principal payments?
- If the holding company will repay debt/hybrid instruments with an additional issuance, or the interest rate on the instrument is adjustable, what is the interest rate risk?
- What ratings on its debt or hybrid securities has the holding company received from nationally recognized credit organizations?

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

[2] Tangible Capital = Capital minus intangible assets.

Calculate the parent company leverage by looking at the debt to capital ratio. Include trust preferred or other hybrid instruments in the numerator with long-term debt:

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

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 the company's earnings power primarily dictates the acceptable level of long-term obligations. Accordingly, you should focus your review on the ability of the company to generate cash flow to meet its fixed debt service. The higher the debt ratio, the more attention you should focus on holding company cash flow needs and earnings power. You should be sensitive to long- and short-term trends and management's plans for using leverage.

You should also compute the total debt to equity ratio on a book and market value basis including trust preferred securities or other hybrid instruments with total debt in the numerator.

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

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

If the market value of equity is higher than the book value, the market value ratio will be lower than the book value ratio. 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 market value ratio will exceed the book value ratio, indicating the market will only provide capital at a discount to book value.

Note: For holding companies with significant nonthrift operations, the ratio of debt to total assets may be more meaningful. 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.) Ratios over ten percent may require follow-up. You should also compare the ratios to the holding company's peers.

Another important step in analyzing parent company leverage is calculating the debt leverage ratio. Include trust preferred securities along with long-term debt in the numerator and denominator.

$$\underline{\textit{Debt Leverage Ratio}} = \frac{\text{Long-Term Debt}}{\text{Long-Term Debt plus Capital}}$$

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

Simple versus Double Leverage

The parent company may advance the proceeds of long-term debt or hybrid instruments to the thrift as debt or equity. Simple leverage exists when the holding company advances the proceeds as debt. Such debt should have repayment terms matching those of the holding company, and the thrift should service it from its current earnings. Double leverage exists when the holding company invests funds it obtains from debt or hybrid instrument proceeds into the thrift subsidiary as equity. Increasing the capital base of the thrift allows the thrift to increase its borrowings, 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.[3] This 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 evident, as holding companies may not directly allocate parent level debt/hybrid instruments to provide equity in the thrift. You can use the double leverage ratio as a proxy to identify the role of double leverage:

$$\underline{\text{Double Leverage Ratio}} = \frac{\text{Thrift \$ Equity}}{\text{Holding Company \$ Equity}}$$

Higher ratios or a trend of increasing ratios can indicate the existence or growth of double leverage in the holding company/thrift relationship. A ratio of 100 percent indicates that there is no double leverage in the organization, while a ratio of 125 percent indicates that the thrift derived 20 percent of its equity capital from sources other than parent equity investments. You should review the impact of double leverage on both the holding company and the thrift.

You should also identify when nonthrift subsidiaries of highly leveraged holding companies experience operating problems. Even when the holding company does not advance debt/hybrid instrument proceeds to the thrift, the parent may rely on the thrift for cash flow. This can 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 stability of the holding company or the thrift, you must immediately advise the Regional Director. It may be 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 have a holding company composite rating of 3, 4, or 5; or

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

- That would cause supervisory concern by issuing additional debt.

Quality and Availability of Capital

Capital provides a secondary source of financial protection for the holding company if operating capacity is 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 the holding company can sell selected assets, use the capital to secure new debt, or issue new equity. A particular capital position can be a function of a company's accounting practices, and you should not view capital 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 shield a company's true capital position.

OTS typically considers three capital measures in determining thrift holding company capital sufficiency:

GAAP Equity

Before you can calculate any relevant quantitative capital measures, you must determine the GAAP total equity of the holding company. GAAP total equity represents the aggregate of holding company equity, including all subsidiaries, after the elimination of intercompany items. The holding company must compute total equity in accordance with GAAP, or some other approved regulatory accounting for functionally or foreign regulated affiliates. For functionally or foreign regulated affiliates, 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 what effect they could ultimately have on other subsidiaries in the enterprise, including the subsidiary thrift.

Holding companies report GAAP equity on their financial statements in accordance with generally accepted accounting principles (GAAP). OTS does not adjust this number, which companies often express as a percentage of consolidated total assets. You must review GAAP equity relative to risk to accurately assess a holding company's capital adequacy.

Tangible Capital

Tangible capital is a more conservative measure than GAAP equity. You derive tangible capital by deducting intangible assets from GAAP equity. In banking organizations, mortgage servicing rights are often the largest intangible asset. You may express tangible capital as a percentage of tangible assets (consolidated total assets minus intangible assets).

Proxy Regulatory Measure

Banking regulators may impose regulatory capital levels that rely on additions or deductions from GAAP equity. Other functional or foreign regulators may also impose regulatory capital measures that rely on adjusting a common capital calculation to meet regulatory requirements. This measure becomes less helpful for diversified holding companies that engage in financial and commercial activity, which have a much different balance sheet than monoline financial companies. Nevertheless, such an analysis can lead to important findings. OTS considers regulatory conventions, including the thrift and the bank holding company regulatory capital framework, when appropriate for its assessment of the holding company's financial condition.

Although savings and loan holding companies (SLHCs) are not subject to an explicit uniform minimum regulatory capital requirement, if a thrift holding company's activities are mostly banking-related, OTS performs a proxy regulatory capital calculation. Calculating a regulatory proxy facilitates comparison with bank holding company peers. OTS calculates the capital level by including or deducting certain balance sheet items to create an approximation of a Tier 1 core capital calculation. You should calculate a proxy using the formula below:

Proxy Formula

Tier 1 Proxy	**Numerator Calculation**
HC630	Consolidated HC Total Equity
HC620	***Plus*** Minority Interests[4] (see discussion below on restricted elements)
HC670	***Plus*** Trust Preferred Instruments (see discussion below on restricted elements)
HC655	***Minus*** Intangible Assets (Nonmortgage Servicing Assets and Others)
	Denominator Calculation
HC600	Consolidated Total Assets
HC655	***Minus*** Intangible Assets (Nonmortgage Servicing Assets and Others)

There are a few points to note with regard to the *proxy* calculation:

Nonfinancial equity investments. The proxy calculation does not deduct nonfinancial equity investments to recognize the difference in the scope of permissible activities for SLHCs. Depending on the risk and amount of nonfinancial investments, you may choose to exclude all or a portion of nonfinancial equity investments.

[4] On December 4, 2007, the FASB issued Statement No. 160, "Noncontrolling Interests in Consolidated Financial Statements" (FAS 160). As a result, the noncontrolling interest (minority interest) will be reclassified from a liability or "mezzanine" item to equity, and reported in the consolidated statement of financial position within equity, separately from the parent's equity. FAS 160 will become effective for most entities with a calendar year-end on January 1, 2009. The proxy formula will be modified accordingly once this change in GAAP is implemented.

Restricted elements – Noncummulative perpetual preferred stock (including trust preferred securities and other hybrid investments) and minority interest. In the proxy calculation you should limit the amount of these investments to 25% of the tier 1 proxy capital amount (15% for large internationally active holding companies[5]). This limit should also include all minority interest except that related to qualifying common or noncumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary.

Reaching a Conclusion on Capital Sufficiency

You must assess capital sufficiency on qualitative and quantitative factors. To determine whether the holding company's capital is sufficient, you should answer several questions:

- How do the different measures of capital compare and do they highlight any particular weakness?
- To what extent does the holding company rely on trust preferred securities or other hybrid equity securities as a source of financing? Did you include such securities as restricted elements in the regulatory proxy calculation? Is the amount of restricted elements approaching 25 percent of the regulatory proxy calculation? If you did not compute a regulatory proxy measure, you should closely scrutinize any holding company that has trust preferred securities, or similar hybrid 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?

[5] An internationally active holding company is defined as one that has 1) total consolidated assets equal to $250 Billion or more or 2) on a consolidated basis reports total on-balance-sheet foreign exposure of $10 Billion or more. The 15% limit increases to 25% for trust preferred securities that mandatorily convert into an equity instrument within a short period.

As you review capital, 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, consistent, and recurring operating earnings and cash flow.

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

- Demonstrably weak or ineffective management;
- Poor asset quality;
- A history of weak earnings or reliance on nonrecurring earnings;
- 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 higher risk activities, 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.

DIVIDENDS

Dividends are the primary way that organizations provide return to shareholders on their investment. During profitable periods, dividends represent a return of a portion of an organization's net earnings to its shareholders. During less profitable periods, dividend rates are often reduced or sometimes eliminated. The payment of cash dividends that are not fully covered by earnings, in effect, represents the return of a portion of an organization's capital at a time when circumstances may indicate instead the need to strengthen capital and concentrate financial resources on resolving the organization's problems.

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.

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 calculate the dividend payout ratios for the parent and any holding company subsidiaries.

$$\underline{\textit{Dividend Payout Ratio}} = \frac{\text{Dividends Paid}}{\text{Net Income}}$$

The holding company's dividend payout ratio should be reasonable and consistent with its existing business plan. You should compare the dividend payout ratio, net income, and asset growth of each significant affiliate of the holding company. When analyzing holding company dividends the following guidance applies:

- 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.
- Generally, a holding company and its thrift should avoid borrowing funds for stock repurchases, or to provide for the payment of dividends to shareholders of the holding company. (Management may propose this when it wants to avoid the negative market reaction that may result if it cuts the dividend. Similarly, the company may need borrowing if its cash flows are seasonal, 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 prospective rate of earnings retention should be consistent with the organization's capital needs, asset quality, and overall financial condition. Dividends should not be paid if there is a reasonable expectation that the capital will be needed to support the subsidiary thrift or to cover losses, deteriorating asset quality, or downturns in the economy.

The inability to sustain or increase stockholders' dividends may demonstrate holding company weaknesses. Often, the suspension of dividends results from a shortage of liquidity. Even the perception of the holding company running low on cash can lead to repercussions for its subsidiaries. When the thrift subsidiary's public identity links to the holding company, a crisis or loss of confidence in the holding company could adversely affect the subsidiary regardless of its financial stability. For example, consumers not familiar with the distinction between the thrift and its parent may withdraw deposits if there is the perception that the holding company is running out of cash. To avoid loss of market confidence, a thrift may face pressure to provide extra support to a holding company or affiliate to avoid a crisis.

CAPITAL MANAGEMENT AND OVERSIGHT

Strong capital management is a positive qualitative factor affecting the adequacy of capital. Managers and directors should anticipate capital needs and maintain adequate capitalization. Holding company management should develop a capital management plan if the holding company's ratios are low or fluctuating relative to others with similar risk profiles in its industry. A good plan outlines management's specific strategies to reach its established goals.

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

- Peer comparison of capital ratios;
- Risk concentrations in credit and other activities;
- Current and desired credit-agency ratings; and
- Historical experiences, including severe adverse events.

Many holding companies and other financial organizations use stress testing and scenario analysis as tools to estimate unexpected losses. This 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 management to input different assumptions and thereby foresee potential consequences.

Holding companies should demonstrate sound capital and risk management. One method of demonstrating this is to meet an objective measure of financial health, such as a target public-agency debt rating or a statistically measured maximum probability of becoming insolvent over a given time horizon. This latter method is the foundation of the Basel Framework's treatment of capital requirements for market and foreign-exchange risk. Risk assessment must address all relevant risks including credit risk, market risk, liquidity risk, interest rate risk, operational risk, legal risk, and others.

You should criticize a holding company without adequate procedures to estimate and document the level of capital necessary to support its activities.

You should interview holding company management to identify its plans for ensuring a safe cushion of capital. During your conversations, you also should emphasize that the holding company's level of capital is a major consideration in the overall examination rating. Specifically, you should inquire whether it plans:

- 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.

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 because holding company management has some discretion for the allocation of capital within the organization. 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 documented analysis of the capital it needs to support its activities. Capital levels should be risk sensitive.

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

The capital rating reflects the adequacy of an enterprise's consolidated capital position, from a regulatory perspective and an economic capital perspective, as appropriate to the holding company enterprise. During your review of capital adequacy, you should consider the risk inherent in an enterprise's activities and the ability of capital to absorb unanticipated losses, to provide a base for growth, and to support the level and composition of the parent company and subsidiaries' debt. The capital rating is based on the following rating definitions:

- ***Capital Rating 1.*** A rating of 1 indicates that the consolidated holding company enterprise maintains a more than sufficient amount of capital to support the volume and risk characteristics of its business lines and products; to provide a significant cushion to absorb unanticipated losses; and to fully support the level and composition of borrowing. In addition, the enterprise has more than sufficient capital to support its business plans and strategies, it has the ability to enter capital markets to raise additional capital as necessary, and it has a strong capital allocation and planning process.

- ***Capital Rating 2.*** A rating of 2 indicates that the consolidated holding company enterprise maintains sufficient capital to support the volume and risk characteristics of its business lines and products; to provide a sufficient cushion to absorb unanticipated losses; and to support the level and composition of borrowing. In addition, the enterprise has sufficient capital to support its business plans and strategies, it has the ability to enter capital markets to raise additional capital when necessary, and it has a satisfactory capital allocation and planning process.

- ***Capital Rating 3.*** A rating of 3 indicates that the consolidated holding company enterprise may not maintain sufficient capital to support the volume and risk characteristics of certain business lines and products; the unanticipated losses arising from the activities; or the level and composition of borrowing. In addition, the enterprise may not maintain a sufficient capital position to support its business plans and strategies, it may not have the ability to enter into capital markets to raise additional capital as necessary, or it may not have a sufficient capital allocation and planning process. The capital position of the consolidated holding company enterprise could quickly become insufficient if there is deterioration in operations.

- ***Capital Rating 4.*** A rating of 4 indicates that the capital level of the consolidated holding company enterprise is significantly below the amount needed to ensure support for the volume and risk characteristics of certain business lines and products; the unanticipated losses arising from activities; and the level and composition of borrowing. In addition, the weaknesses in the capital position prevent the enterprise from supporting its business plans and strategies, it may not have the ability to enter into capital markets to raise additional capital as necessary, or it has a weak capital allocation or planning process.

- ***Capital Rating 5.*** A rating of 5 indicates that the level of capital of the consolidated holding company enterprise is critically deficient. Immediate assistance from shareholders or other external sources of financial support is required.

SUMMARY

The capital sufficiency of a holding company is a critical factor in the regulation of thrift holding companies. You must consider the:

- Necessary capital based on the risk exposure of each holding company and nonbank subsidiary activity;
- Relationship between debt, hybrid instruments, 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;
- Ability of management to devise capital plans for capital deficiencies or planned expansions;
- 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, and deferred tax assets; and
- Extent of off-balance sheet exposure.

HYBRID INSTRUMENTS

Hybrid capital instruments have characteristics of both common stock and unsecured debt. They resemble debt because they generally pay a fixed or floating interest rate, coupon, or dividend. At the same time, these securities are deeply subordinated, often have long maturities, and may be similar to common equity in their ability to absorb losses. Banking organizations in the United States rely on hybrid capital instruments and other innovative instruments for capital funding. Sources of hybrid capital funding are continually evolving. These sources of funding, especially if double leveraged,[1] can increase an institution's risk profile by generating substantial pressure to maintain earnings to support dividend payments. An institution's over-reliance on double leverage will trigger increased supervisory scrutiny.

Advantages to issuers for considering hybrid instruments include a lower cost of capital, tax deductibility, regulatory and rating agency equity credit recognition, and diversity in funding source. However, the overuse of hybrid instruments could lead to increased levels of risk that warrant management's close attention. Risks may include increased leverage, a thinner capital base for the consolidated organization (including both the savings association and its holding company), increased interest rate risk, and increased funding and liquidity risks.

During the thrift and holding company examinations, as well as through ongoing supervisory monitoring, OTS will review capital levels and the ability to service debt both individually and on a consolidated basis. While hybrid capital instruments can help banking organizations manage their capital structure, OTS expects parent-infused Tier 1 capital to derive predominantly from voting common stock or retained earnings of its parent. In addition, OTS considers the following features as guiding principles when evaluating hybrid instruments: loss absorption ability, permanence of the instrument, ability to suspend dividend payments, and certainty in cost of funding.

Some of the more familiar types of hybrid capital instruments include trust preferred securities (TPS) and asset-driven securities, particularly real estate investment trust (REIT) preferred securities. There are also innovative hybrid instruments such as mandatory convertible preferred securities and enhanced trust preferred securities that have resulted from regulatory and rating agency changes.

Trust Preferred Securities

Trust preferred securities are non-perpetual cumulative preferred securities. In most cases, the holding company establishes a special purpose entity (SPE), usually in the form of a trust, to issue the securities. The SPE issues preferred securities to outside investors. With the proceeds, the SPE purchases an equivalent amount of junior subordinated debentures with stated maturities from the holding company. The subordinated note, which is senior only to a holding company's common and preferred stock, has terms that generally mirror those of trust preferred securities, except that the subordinated note often has a fixed maturity of at least 30 years.

Generally, the terms of the trust preferred securities allow the trust to defer dividends for at least a twenty-consecutive-quarter period without creating an event of default or acceleration. If the trust fails to pay the

[1] For a source of capital, savings associations sometimes rely on debt the holding company issues. Double leverage exists when a holding company invests funds it obtains from debt proceeds into the savings association as equity. Increasing the capital base allows the savings association to increase its borrowings as well, thereby compounding the original holding company debt resulting in higher consolidated leverage.

cumulative dividend after this period, default occurs, and the principal and interest on the note becomes immediately due and payable. Dividends paid on trust preferred securities are a tax deductible interest expense thus representing a key advantage for holding companies.

Pooled issuances of trust preferred securities typically involve thirty or more separate holding company issuers and have made the issuance of trust preferred securities possible for small holding companies, most of which did not previously have this form of capital market access.

Real Estate Investment Trust (REIT) Preferred Securities

Subordinate organizations of the savings association often issue REIT preferred securities. A thrift-controlled REIT issues noncumulative perpetual preferred securities into the market and uses the proceeds to buy mortgages and mortgage-backed securities from its majority common shareholder, its parent institution. A SPE must qualify under federal tax laws to be a REIT. The two main qualifications for a REIT are that it must (a) hold predominantly real estate assets and (b) annually pay out a substantial portion of its income to investors. The benefit of qualifying as a REIT is that its income is not subject to an entity-level tax. Rather, taxation occurs at the investor level.

In a typical structure where the thrift controls a REIT, the REIT subsidiary preferred securities, in general, could qualify for inclusion in Tier 1 capital as minority interests in a consolidated subsidiary subject to certain prudential standards. The terms and conditions include but are not limited to a capital limitation and a convertibility provision. Preferred securities may constitute no more than 25 percent of a savings association's Tier 1 capital. In addition, the convertibility provision allows the thrift to exchange noncumulative REIT preferred securities directly for issued noncumulative perpetual preferred securities of the parent institution upon the occurrence of certain events, such as the institution becoming undercapitalized, going into receivership, or at the direction of the regulator.

Enhanced Trust Preferred Securities

Enhanced trust preferred securities have more equity characteristics than traditional trust preferred securities and receive equity credit from credit-rating agencies. Revised rating agency guidelines that allow partial equity credit treatment of these securities has driven the growth of enhanced trust preferred securities. Enhanced trust preferred securities differ from traditional trust preferred securities in several ways:

- A longer maturity of 60-80 years versus 30 years;
- A longer deferral period of ten years versus five years;
- Inclusion of replacement capital covenant (similar hybrid security needs to be issued to replace an existing hybrid in the event of redemption); and
- Alternative payment mechanism (permits issuer to settle omitted coupon payments in cash via the market issuance of securities, or by giving the hybrid holder equity-like securities).

Mandatory convertible preferred securities

Mandatory convertible preferred securities involve the joint issuance by a holding company to investors of trust preferred securities and a forward purchase contract. The forward contract obligates the investors to purchase a fixed amount of the holding company's common stock, generally in three to five years.

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Introduction

In the Organizational Structure component of the holding company examination, you will assess the operations and risks in the holding company enterprise. You will consider the enterprise's corporate structure, its lines of business, affiliate relationships, concentrations, exposures, and the overall risk inherent in the structure. Your analysis should consider existing as well as prospective issues and risks. In this section it is important that you identify material shifts or changes in organizational structure and the reasons for the changes, including plans for future structural changes.

Every holding company enterprise has a unique structure with different risks and issues. These risks change from enterprise to enterprise and over time within a given holding company enterprise. This section highlights several types of holding company structures. It is important to review and understand each structure. This section also provides an overview of control thresholds to help determine if there have been changes in the ownership structure, and, if so, what regulatory processes apply. In addition, it outlines the framework for determining the activities in which a holding company may engage. There is a correlation between the holding company structure and its permitted activities.

LINKS
Appendix A
Appendix B
Appendix C

The review of organizational structure will vary based on the size and complexity of the holding company. The review will be simple for noncomplex holding companies. In most of those cases, you can apply your analysis of the risks at the thrift to the holding company review with limited additional analysis. For more complex holding companies and financial conglomerates, you should conduct a more detailed assessment of the holding company's level and type of risk exposure. You should evaluate the following risk types, as applicable:

- Credit/Asset
- Market
- Liquidity
- Operational
- Legal/Compliance
- Reputation
- Country/Sovereign

- Contagion/Systemic
- Concentration
- Intra-group transactions
- Pricing and Underwriting
- Reserving
- Strategic/Execution

You will identify the inherent risks in the holding company enterprise and assess the level of risk. In determining the level of risk, you should consider risk concentrations and exposures throughout the company to accurately assess the risk of the enterprise. In the Risk Management section, you will assess how effectively the holding company identifies, manages, monitors, and controls the risks that you identify in this section.

In conducting the holding company examination, you also should determine how the thrift institution fits in the overall corporate structure. You should consider whether there are elements of the holding company structure, or business interests of the holding company enterprise, that hold potential risks for the thrift. For example, a holding company or one of its affiliates may be using the thrift to hold low-quality or high-risk assets or as a vehicle for conducting risky activities. You should discuss your findings from the holding company examination with the savings association's caseload manager and/or examination team.

You should review material intra-group transactions and identify concerns or weaknesses. You should also consider the materiality of specific companies or lines of business, including the thrift, to the holding company enterprise and its controlling shareholders. Use your discretion in determining materiality. You should base your analysis on a combination of financial, risk exposure, and strategic business planning information. If a line of business is immaterial to the holding company or controlling shareholders, there may be less incentive for them to ensure the viability of its operation or to provide financial support. On the other hand, the holding company may want to avoid reputation risk by doing whatever is necessary to address problems. The holding company may divert resources to the troubled affiliate to protect the company's reputation.

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**. The majority of thrift holding companies are unitary.

- A **unitary** holding company controls one thrift.

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

Many times a holding company is noncomplex and its sole purpose is ownership of a thrift. These 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.

OTS designates thrift holding companies as **diversified** or **nondiversified**. This distinction is based on the business interests of the company. The majority of OTS-regulated holding companies are nondiversified.[1]

- A **diversified** holding company's thrift and related activities[2] represent less than 50 percent of the company's consolidated net worth and consolidated earnings.
- A **nondiversified** holding company does not meet those thresholds, and banking or related businesses are its principal operations.

You may also encounter other types of holding companies that own thrifts including a **mutual holding company (MHC)**, a **HOLA 10(l) holding company**, and a **bank** or **financial holding company**.

An MHC structure combines the elements of a mutual thrift, which is owned/controlled by its depositors (or 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. Handbook Section 920 contains specific examination issues for mutual holding companies.

Section 10(l) of the Home Owners' Loan Act (HOLA) established HOLA 10(l) holding companies by allowing state savings banks and cooperative banks that are not OTS-regulated to elect to be treated as savings associations for purposes of regulating their holding company. Without such an election, the Board of Governors of the Federal Reserve (Federal Reserve) would regulate these holding companies 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. Handbook Section 910 contains specific examination issues for this population of holding companies.

[1] A holding company must claim its diversified status. To claim this status, it has to demonstrate that it meets the above percentages. Historically, diversified holding companies were exempt from certain regulatory requirements. The most notable exception dealt with debt notices. Today, few regulatory distinctions remain. The management interlock regulations contain one exemption that still exists for diversified holding companies.

[2] 12 CFR 584.2(b), 584.2-1 and 584.2-2 define related activities.

Bank or financial holding companies can control a thrift as well as a bank. In structures where a thrift is controlled by a bank or financial holding company, the Federal Reserve is the primary regulator of the holding company because of its bank ownership. OTS is the primary regulator of the thrift itself, but does not regulate the holding company. OTS will coordinate and provide relevant information to the Federal Reserve regarding material concerns that arise at a thrift subsidiary of a bank or financial holding company.

The holding company examination encompasses a review of the entire holding company enterprise. Structure is one of the first indicators of how to review a holding company enterprise from an examination perspective. Understanding the structure is essential to make an effective assessment of the holding company. There is a substantial difference in approach between a low risk, noncomplex holding company compared to a complex, diversified holding company that is involved in multiple nonbanking businesses. Understanding the structure also makes it easier to focus attention on the entities that are material and pose potential risk to the enterprise or its affiliates, including the subsidiary thrift.

ACQUISITIONS AND CONTROL

The issue of control is significant in the regulatory process since it determines who has the power over management, policies, and the direction of the thrift or holding company.[3] It is also important to be aware of potential acquirers of control. There are specific statutory and regulatory requirements that apply to companies that directly or indirectly control a thrift. 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 properly identified itself, and, therefore, has not received the requisite approvals from OTS.

Persons or entities exercising 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 identify control issues and be alert for 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 interests of the holding company or its controlling shareholders and lacks support or oversight.

Control of a thrift or holding company can take multiple forms and sometimes is not obvious. Some simple facts about control include:

- Control can be direct or indirect.
- Control can occur by persons or entities acting in concert to influence the thrift or holding company.

[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.

- Control can occur by means other than stock ownership.

Control of a thrift or holding company is often straightforward based on stock ownership or the ability to control the stock. The parties involved ordinarily acknowledge control and undertake the proper application or notification process with OTS. However, there are also situations where the question of control is less clear. You should identify and monitor these situations to be aware of possible control issues which have not been acknowledged, and which OTS has not reviewed.

Control may arise due to changes beyond the new controlling entity's or person's actions. For example, if a holding company or thrift repurchases stock on a non pro rata basis, the 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. 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 at 12 CFR Part 574. Determinations of control can be complex, and OTS may have to draw conclusions outside the scope of the examination. However, it is important that you are aware of the significant elements of control to identify and make preliminary assessments of potential control issues.

Conclusive Control

Conclusive control is where an acquirer, either person or entity, owns or controls more than 25 percent of the voting stock of a thrift or holding company. This can arise from outright ownership, 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 has 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 entity does not have conclusive control, but there are combined circumstances present that suggest that a controlling influence exists. 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. Section 574.4(c) of the regulation outlines possible control factors. 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:

- Acknowledge its intent to control and obtain the appropriate approvals; or

- Successfully rebut control.

In the latter case, OTS must accept the rebuttal before the acquirer consummates the transaction. 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 scrutiny of an acquisition filing. However, if OTS does not accept the rebuttal, the acquirer would have to proceed with an application or notice to OTS in the normal course of acquisition.

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 a process whereby persons or entities exercise conclusive or rebuttable control by acting collectively. 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, OTS may consider parties to act in concert under the general definition at 574.2(c).

Other Control-related Filings

In addition to rebuttals of control and concerted actions, there are multiple other filings related to control. The Applications Processing Handbook contains application forms and detailed filing instructions for holding companies and ownership control.[4] If you identify a control situation where an entity or individual has not filed an appropriate application or notice, 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 instances where OTS does not require approval or notice or allows them after the acquisition. One example is where control results from a pledge or hypothecation of stock to secure a loan.

Companies seeking to acquire control of a thrift or thrift holding company must file one of several holding company acquisition filings. OTS refers to them as H-(e) applications. When an individual seeks to acquire control, the acquirer must file a Change-in-Control notice. Section 574.6 sets forth the procedural requirements and outlines the appropriate type of application or notice for each acquirer. OTS requires these processes 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. 12 CFR 574.5 specifies the required language of the certification.

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

PERMISSIBLE ACTIVITIES

Once you have a clear understanding of the holding company structure, including identifying all controlling parties and affiliates, you can analyze the holding company's activities. The permissible activities of a holding company are dependent on many factors. Some holding companies operate without any activities limitations, while others are subject to activities restrictions. Even when activity restrictions apply, there are a significant number of permissible, banking-related businesses. Therefore, it is important that you review what activities the holding company enterprise conducts 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 summarizes the factors that determine permissible activities. 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**

Type of Holding Company

Beyond the basic definition of a multiple holding company, if an insider of the holding company controls another thrift, then special treatment will apply. Specifically, if an individual meeting certain criteria controls more than one savings association (directly or indirectly), OTS will treat any holding company

[5] 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.

controlled by that individual 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 (including proxies) 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. To qualify as a supervisory acquisition, the holding company must invoke 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.

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

Date of Acquisition or Application

The Gramm-Leach-Bliley Act (GLBA) of 1999, restricted the creation of new thrift holding companies that engage in commercial or other nonfinancial activities. GLBA grandfathered most holding companies in existence at the time. Specifically, those holding companies that were in existence or had filed an application on or before May 4, 1999, to acquire a thrift, can operate without activity restriction if:

- 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 OTS on or before that date; and
- The subsidiary thrift(s) have QTL status.

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 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 nine 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 portfolios without the consequence of losing 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 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 the holding company or other affiliates conduct 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 activity that the Board of Governors of the Federal Reserve System (Federal Reserve) 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);
- Any activity that the Federal Reserve permits for financial holding companies with foreign operations under Section 4(c) of the Bank Holding Company Act; and
- Any activity that multiple savings and loan holding companies were authorized (by regulation) to engage in directly on March 5, 1987.[6]

Appendix 400B contains a summary list of permissible activities for Savings and Loan Holding Companies.

[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 in which thrift holding companies may engage, 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 when a thrift holding company is evading a law or regulation. Often, a company structures its operations to take full advantage of the flexibility that the holding company and its subsidiaries possess without intending to evade laws or regulations. You must assess the holding company's purpose and intent, as well as the effect on the thrift, when making your determinations.

Multi-State Multiple Holding Companies

Section 574.3(e) generally prohibits the formation of an interstate multiple thrift holding company. Unless the acquisition meets certain criteria, 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 prior written 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 permissible activities.

Management Interlocks

The Depository Institution Management Interlock Act[7] and the OTS's management interlocks regulation[8], promote competition by generally prohibiting a management official from serving simultaneously with two unaffiliated depository institutions or their holding companies when 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, there is *generally* a prohibition on management interlocks if the unaffiliated depository organizations, or any of their affiliates, have offices in the same community. Management officials also cannot serve two unaffiliated depository organizations with offices or a depository institution affiliate in the same Relevant Metropolitan Statistical Area (RMSA) if both institutions have assets of $50 million or more. A management official of a depository organization (or any depository institution affiliate) with assets over $2.5 billion may not serve as a management official at an unaffiliated depository organization (or any depository institution affiliate) with assets over $1.5 billion.

[7] See 12 USC Sections 3201-3208.

[8] See 12 CFR 563f.

If management interlocks exist, you need to determine if the interlock is a permitted interlocking relationship as noted in 12 CFR Section 563f.4. If not, the institution or its holding company may apply for OTS to provide a general exemption or to determine eligibility for a small market exemption. OTS may grant an exemption if the official's dual service does not result in a monopoly, a substantial lessening of competition, or threaten safety and soundness. The small market share exemption allows interlocks for depository organizations (and affiliates) that in aggregate hold no more than 20 percent of the deposits in each common RMSA or community, 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 annually.

Management must institute corrective action if it did not obtain a required prior approval. You can detect the existence of management interlocks through interviews, reviewing minutes, contacting other agencies, or reviewing other public records (i.e. Lexis/Nexis or Westlaw).

Prohibited Service

Section 19(e) of the Federal Deposit Insurance Act (FDIA) places prohibitions on any person with a conviction for any criminal offense involving dishonesty, breach of trust, or money laundering or who has agreed to enter into a pretrial diversion or similar program in connection with a prosecution for such an offense. Those individuals may not become, or continue as, an institution-affiliated party of an insured depository institution; own or control, directly or indirectly, any insured depository institution; or otherwise participate, directly or indirectly, in the conduct of the affairs of any insured depository institution. The Financial Services Regulatory Relief Act of 2006 expanded the prohibited service outlined in FDIA to include savings and loan holding companies.

In your review, you should assess the ownership structure of the holding company to determine whether there are any prohibited individuals. OTS regulation 12 CFR part 585 outlines the prohibitions. Part 585 also provides limited exceptions for certain employees. If you identify prohibited individuals, you should assess whether they applied to OTS for an exemption. The Director of OTS may also approve case-by-case exemptions.

You should consider the results of your review of prohibited service when you review corporate governance and the composition of the board of directors and senior management in the Risk Management section of the Holding Company Handbook.

Other Prohibited Acts

Section 584.9 outlines other prohibitions regarding control of mutual thrifts.

Risk Assessment

Holding companies' activities are diverse and expose the companies to a spectrum of risk. Assessing the inherent risks of the holding company enterprise is an essential element of the Organizational Structure review. For a complex holding company enterprise, you should identify material operations, legal entities, and business lines. Once you understand the holding company's structure, ownership and control issues, and permissible activities, you can complete your analysis of the risk of that structure and activities.

You should identify and assess the risk exposures within material entities and across company lines.

You should identify and assess the risk exposures within material entities and across company lines. The risks these activities create can range from minor to significant and from permissible to inappropriate. Different entities within the enterprise might have exposure to the same or similar risk factors, or to unrelated risk factors that may interact under stressful scenarios. Increased risk taking in holding company investments or businesses can be detrimental to the holding company as well as its subsidiaries and affiliates.

The examination should review the current and prospective businesses and investments of the holding company enterprise and assess the level of risk. You should identify and assess any material acquisitions, dispositions, or other structural or strategic changes. You should also review whether the holding company's risks are similar to its peers and whether investments and other assets are typical for the business or more speculative. You should consider how these risks affect the insured thrift. In your assessment, you should also identify and consider potential future risks for the enterprise. The fact that a company meets legal and regulatory objective criteria for its structure does not alleviate supervisory concerns.

In your assessment of risk you should incorporate the viewpoints of the holding company's internal audit risk assessment or other enterprise-wide risk assessment systems. For complex companies, you should reference Section 200, Appendix B thereto includes a risk assessment matrix that examiners should use to document their assessment of risk. The risk assessment matrix relies on identifying inherent risks (Organizational Structure) and the effectiveness of controls to manage those risks (Risk Management).

You should identify the level and extent of the following types of risk in the holding company enterprise:

Credit/Asset Risk

Credit risk is one of the most common and serious forms of risk. It arises from the potential that a borrower or counterparty will fail to perform on an obligation in accordance with agreed terms. Counterparties can include individuals, businesses, sovereign governments, and many others. Their obligations can range from personal and business loans to derivatives transactions. Credit risk arises from both on- and off-balance sheet transactions. A related risk is asset risk (also known as investment risk), which is the risk related to market changes or performance of a financial asset.

Market Risk

There are several types of market risk you should assess, including interest rate, currency, commodity, and equity risk. Interest rate risk is a company's financial exposure to movements in interest rates. Currency risk results from exposure to changes in the values of foreign currencies. Commodity risk arises when the values of particular commodities change (i.e. precious metals, oil, etc.). Equity risk results from fluctuations in stock prices. The complexity of each type of market risk will vary based on the complexity of the holding company enterprise and its investments.

Liquidity Risk

Liquidity risk is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (funding liquidity risk). Liquidity risk also arises when a company cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (market liquidity risk). Liquidity risk increases when companies experience unexpected cash outflows or downgrades in credit ratings. Liquidity risk is often higher in low volume markets or emerging markets where there are not as many market participants.

Operational/Transaction Risk

Operational risk arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected, direct, and indirect losses. Operational risk can be internal (processes, people, or systems) or external. Business lines with high turnover, tight deadlines, large volumes, and complex support systems have the most operational risk exposure. Transaction risk is a similar risk that arises directly from the inability to deliver products or services because of fraud, error, or system deficiencies. This risk is a function of internal controls, information systems, employee integrity, and operating processes.

Legal/Compliance Risk

Legal risk is a form of operational risk that arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of an organization. Compliance risk arises from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, or ethical standards.

Reputation Risk

Reputation risk arises when a company's business practices receive negative publicity that may result in a decline in the customer base, costly litigation, or revenue reductions. Aside from the public reaction, the risk exposure also includes the effect of negative publicity on government or regulatory agencies in the countries in which it operates, or intends to operate. Even minor subsidiaries with limited operations can expose the enterprise to significant risk when they operate under the corporate name. The appearance of inappropriate activities within the enterprise will result in greater scrutiny of the enterprise as a whole.

Country/Sovereign Risk

Country risk arises from the general level of political, financial, and economic uncertainty in a country, which affects the value of the country's bonds, equities, and business activities. Sovereign risk is the risk that a central bank or other government body will impose foreign exchange regulations or other restrictions that will reduce or negate the value of foreign exchange contracts and other business transactions. It also refers to the risk of government default on a loan made to a country or guaranteed by it.

Generally, there is higher risk exposure in emerging markets or markets where senior management and the board are not familiar with local government, customs, or the economic environment. In your assessment of this risk area, you should attribute higher risk exposure to markets where the holding company has less experience or does not evidence a full understanding of the unique considerations of that country.

Contagion/Systemic Risk

Contagion risk is the risk that financial difficulties encountered by a business line or subsidiary of a holding company could have an adverse impact on the financial stability of other entities or the entire enterprise. In extreme cases, contagion risk can extend to the markets in which the enterprise or its affiliates operate. Systemic risk results from financial system instability and can be potentially catastrophic. Idiosyncratic events or conditions in financial intermediaries can cause or exacerbate this risk. Impacted areas include market value of positions, liquidity, credit-worthiness of counterparties and obligors, default rates, liquidations, risk premia, and valuation uncertainty.

Strategic/Execution Risk

Strategic and execution risk is the risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of an organization's strategic goals, business strategies, resources, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities. Strategic risk focuses on more than an analysis of the written strategic plan. It focuses on how plans, systems, and implementation affect the enterprise's franchise value. It also incorporates how management analyzes external factors that affect the strategic direction of the company.

Insurance Risks

Please refer to Section 930 of the Holding Company Handbook for a discussion of insurance risks including reserving risk and pricing and underwriting risk.

Risk Concentrations

A risk concentration is an aggregate exposure or loss potential that an entity or entities within the enterprise bear. Risk concentrations are often large enough to threaten the capital adequacy or the financial position of the entities or the holding company enterprise. However, risk concentrations can be material for other reasons, including reputation risk and contagion risk. There can be risk concentrations in an enterprise'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;
- Industry sectors;
- Specific products;
- Service providers; and
- Specific geographic areas.

You should identify the material risk concentrations in the holding company enterprise. Complex and sophisticated holding company enterprises, including conglomerates, should have comprehensive policies and systems to measure, monitor, manage, and report risk concentrations. You should review and assess the sufficiency of the enterprise's policies and procedures for identifying, managing, and reporting risk concentrations as part of your review of the Risk Management component. You should document material risk concentrations in the holding company report of examination.

Intra-group 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. Intra-group transactions are an important element of corporate governance and internal control. Examiners should review all material intra-group transactions in their assessment of Organizational Structure. While intra-group transactions can improve cost efficiency and allow affiliates to leverage off the successes of other parts of the enterprise, the reverse is also true. Intra-group transactions also expose affiliates to weaknesses in other areas of the holding company enterprise. By making an unsound loan or risky investment to an affiliate, the holding company could jeopardize the financial resources it has available to support other subsidiaries. Furthermore, to compensate for a poor investment, the holding company may place additional pressure on the subsidiary to pay dividends, engage in other transactions, or pursue higher yielding investments.

You should identify and review 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 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 holding company enterprise. While 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 to determine the inherent risk of the transactions:

- Holding company documentation and monitoring of intra-group transactions. Does senior management routinely and adequately identify and monitor material intra-group transactions?

- The principal business of the holding company. If the transaction is a loan, and the principal business of the holding company is lending, there may be less of a concern. If the holding company is a nonfinancial company, lending is outside of its primary business and should 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 to the policy? If not, did the board approve the policy exception?

- The terms of the transaction. Did the holding company or affiliate enter into the transaction on favorable terms or at market rates? The more favorable the terms, the greater the possibility of corporate abuse.

- Performance of the intra-group 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. Does management report material intra-group transactions to the board? 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. You should assess 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 within the holding company enterprise. Not only is there reputation risk to the enterprise, but if insiders have found a way to abuse resources, there may be additional instances of abuse. If you identify a material loan or other intra-group transaction that is problematic, you should:

- Bring the transaction to the attention of your manager.

- Discuss the transaction with holding company management.

- Factor the effect of transaction into your assessment of the component and composite ratings.

- Consider what, if any, supervisory measures are appropriate to safeguard the holding company enterprise and its affiliates, including the thrift (for example, limiting dividends from the thrift, requiring prior notice of intra-group transactions, or instructing the holding company to amend its policies and procedures for governing transactions with affiliated entities or insiders).

Transactions with the Thrift

When intra-group transactions directly involve a thrift, the holding company must adhere to specific regulatory requirements. The transactions must also be in the thrift's best interests. Historically, there are two areas of common abuse in the holding company relationship: intra-group transactions and tax sharing arrangements. Holding companies can inappropriately use these arrangements to divert funds from the thrift. OTS reviews thrift payments in the course of the thrift examination, but you should augment this review by cross-checking the holding company's records and its valuation of transactions with those of the thrift. This will allow you to ensure that the holding company properly identifies and records intra-group transactions, including tax payments.

An evaluation of transactions between the holding company and thrift is an important element of holding company examinations of all complexities. In addition to ensuring regulatory compliance and avoiding abuses, evaluating intra-group transactions with the thrift 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;
- Adhere to safe and sound practices; and
- Comply with applicable statutory and regulatory standards.

OTS regulations regarding transactions with affiliates are in 12 CFR 563.41.[9] Beyond identifying specific transactions to determine regulatory compliance, you must also understand the motives for such transactions. For additional information on the restrictions and limitations that apply to affiliate transactions, you should refer to Examination Handbook Section 380, Transactions with Affiliates and Insiders. You should coordinate your review of intra-group transactions with the examiner performing the review of affiliate transactions on the thrift examination.

[9] 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.

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 a separate return. The timing of tax payments between the holding company and its affiliates is also important. For thrift tax sharing agreements, if the timing of tax payments to a holding company is too far in advance of when the holding company must submit its taxes, or if the holding company does not promptly downstream a tax refund due to the thrift, it may be an unsecured loan and a violation of the affiliate regulations. A holding company and its subsidiaries should enter into a written, comprehensive tax allocation agreement. 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 own income taxes;

- 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 November 23, 1998, "Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure" (see Appendix 400C) or contact your regional accountant.

RATING THE ORGANIZATIONAL STRUCTURE COMPONENT

To assess risk at the holding company, you must consider the entire holding company enterprise. The Organizational Structure component is an assessment of the operations and risks in the holding company enterprise. The rating of this component should reflect your evaluation of the organizational structure, considering the lines of business, affiliate relationships, concentrations, exposures, and the overall risk inherent in the structure.

Organizational Structure Rating 1. A rating of 1 indicates that the organizational structure, including the nature and level of risks associated with the affiliates' activities, pose minimal concern. Management controls and monitors intra-group exposures. Any concerns posed by strategic plans, the control environment, concentrations, legal or reputational issues, or other types of risk within the enterprise are minor, and management and the board can address them in the normal course of business.

Organizational Structure Rating 2. A rating of 2 indicates that the organizational structure exhibits minor weaknesses, but the nature and level of risks associated with the holding company's activities are unlikely to be material concerns. Intra-group exposures, including servicing agreements, are generally acceptable, but isolated transactions or exposures may present limited cause for regulatory concern. Concerns posed by strategic plans, the control environment, concentrations, legal or reputational issues, or other types of risks within the enterprise are modest, and management and the board can address them in the normal course of business.

Organizational Structure Rating 3. A rating of 3 indicates that there are organizational structure weaknesses that raise supervisory concern. The nature and level of risks associated with the holding company activities are moderately likely to cause concern. Intra-group exposures, including servicing agreements, have the potential to undermine the financial condition of other companies in the enterprise. Strategic growth plans, weaknesses in the control environment, concentrations, legal or reputational issues, or other types of risk within the enterprise are may cause regulatory concern. The enterprise may have one or more entities in the structure that could adversely affect the operation of other entities in the enterprise if management does not take corrective action.

Organizational Structure Rating 4. A rating of 4 indicates that there are weaknesses in the organizational structure of the enterprise, and/or the nature and level of risks associated with the holding company's activities are, or have a considerable likelihood of becoming, a cause for concern. Intra-group exposures, including servicing agreements, may also have the immediate potential to undermine the operations of companies in the enterprise. Strategic growth plans, weaknesses in the control environment, concentrations, legal or reputational issues, or other types of risk within the enterprise may be of considerable cause for regulatory concern. The weaknesses identified could seriously affect the operation of one or more companies in the enterprise.

Organizational Structure Rating 5. A rating of 5 indicates that there are substantial weaknesses in the organizational structure of the enterprise, and/or the nature and level of risks associated with the activities are, or pose a high likelihood of becoming, a significant concern. Strategic growth plans, a deficient control environment, concentrations, legal or reputational issues, or other types of risk within the enterprise may be of critical concern to one or more companies in the enterprise. The weaknesses identified seriously jeopardize the continued viability of one or more companies in the enterprise.

SUMMARY

There are multiple corporate structures for thrift holding companies. These structures determine the operating ability of the entities and establish how examiners should assess them during the examination. Likewise, control of the entities arises numerous ways. Control may be conclusive or rebuttable. You must be knowledgeable of and identify events that could result in a change of control.

Once you determine the structure and control of the holding company enterprise and identify potential changes, you should examine the actual operation of the entities. You should identify and assess the risk of all material business activities, including determining if the activities are permissible for the holding company structure. Your assessment of risk should also review the enterprise's risk concentrations and intra-group transactions. You should be especially alert for material risks including those that may affect the thrift, so that OTS may initiate appropriate supervisory measures or monitoring.

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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.

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List of Permissible Savings and Loan Holding Company Activities

Advertising. A savings and loan holding company may engage in advertising and other services to procure and retain both savings accounts and loans primarily for affiliates and for savings association subsidiaries, or for multiple savings and loan holding companies and affiliates thereof.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2(b)(3)(vii)
Advisory services. Providing financial, investment, or economic advisory services, including advising an investment company (as defined in section 3 of the Investment Company Act of 1940 (15 USC § 80a-3)).	BHCA Section 4(k)(4)(C)
Agency transactional services. Providing to customers as agent transactional services with respect to swaps and similar transactions, any transaction described in 12 CFR § 225.28(b)(8), any transaction that is permissible for a state member bank, and any other transaction involving a forward contract, option, futures, option on a futures or similar contract (whether traded on an exchange or not) relating to a commodity that is traded on an exchange.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(7)(v)
Appraisals. Performing appraisals of real estate and tangible and intangible personal property, including securities.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(2)(i)
Asset management. Holding, managing, or liquidating assets owned or acquired from a savings association subsidiary of such company.	HOLA Section 10(c)(2)(C)
Asset management, servicing and collection activities. Engaging under contract with a third party in asset management, servicing, and collection (as more fully described in the Federal Reserve Board's regulations) of assets of a type that an insured depository institution may originate and own, if the company does not engage in real property management or real estate brokerage services as part of these services.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(2)(vi)
Asset pools. Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly.	BHCA Section 4(k)(4)(D)

Career counseling. Providing career counseling services to: (i) a financial organization (as described in the Federal Reserve Board's regulations) and individuals currently employed by, or recently displaced from, a financial organization; (ii) individuals who are seeking employment at a financial organization; and (iii) individuals who are currently employed in or who seek positions in the finance, accounting, and audit departments of any company.	BHCA Sections (4)(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(9)(iii)
Certification authority. Acting as a certification authority for digital signatures and authenticating the identity of persons conducting financial and nonfinancial transactions.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.86(a)(2)(iii)
Check cashing and wire transmission services.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.86(a)(2)(v)
Check guaranty services. Authorizing a subscribing merchant to accept personal checks tendered by the merchant's customers in payment for goods and services, and purchasing from the merchant validly authorized checks that are subsequently dishonored.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(2)(iii)
Clerical accounting services. Furnishing or performing clerical accounting and internal audit services primarily for its affiliates.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(2)
Coin purchases and sales. Purchase and sale of gold coins minted and issued by the United States Treasury pursuant to Pub. L. 99-185, 99 Stat. 1177 (1985), and activities reasonably incident thereto.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(11)
Collection agency services. Collecting overdue accounts receivable, either retail or commercial.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(2)(iv)
Community development activities. Making equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas by providing housing, services, or jobs for residents. Also, providing advisory and related services for programs designed primarily to promote community welfare. 12 CFR § 225.127 includes additional information regarding this type of activity.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(12)

Courier services. Providing courier services for: (i) checks, commercial papers, documents, and written instruments (excluding currency or bearer-type negotiable instruments) that are exchanged among banks and financial institutions; and (ii) audit and accounting media of a banking or financial nature and other business records and documents used in processing such media.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(10)(i)
Credit bureau services. Maintaining information related to the credit history of consumers and providing the information to a credit grantor who is considering a borrower's application for credit or who has extended credit to the borrower.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(2)(v)
Credit information, appraisals, construction loan inspections, and abstracting. A savings and loan holding company may provide these services primarily for affiliates and for savings association subsidiaries, or for multiple savings and loan holding companies and affiliates thereof.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(3)(ii)
Credit insurance. Acting as principal, agent, or broker for credit insurance (including home mortgage redemption insurance) that is: (i) directly related to an extension of credit by the bank holding company or any of its subsidiaries; and (ii) limited to ensuring the repayment of the outstanding balance due on the extension of credit in the event of the death, disability, or involuntary unemployment of the debtor.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(11)(i)
Data processing. A savings and loan holding company may furnish or perform data processing services primarily for affiliates and for savings association subsidiaries, or for multiple savings and loan holding companies and affiliates thereof.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(3)(i)
Data processing. Providing data processing, data storage and data transmission services, facilities (including data processing, data storage and data transmission hardware, software, documentation, or operating personnel), databases, advice, and access to such services, facilities, or data-bases by any technological means, if (i) the data to be processed, stored or furnished are financial, banking or economic; and (ii) the hardware provided in connection therewith is offered only in conjunction with software designed and marketed for the processing, storage and transmission of financial, banking, or economic data, and where the general purpose hardware does not constitute more than 30 percent of the cost of any packaged offering.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(14)

A company conducting data processing, data storage, and data transmission activities may conduct data processing, data storage, and data transmission activities not described in the preceding paragraph if the total annual revenue derived from those activities does not exceed 49 percent of the company's total annual revenues derived from data processing, data storage and data transmission activities.	
Debt acquisition. Acquiring debt that is in default at the time of acquisition, if the company: (i) divests shares or assets securing debt in default that are not permissible investments for bank holding companies, within the time period required for divestiture of property acquired in satisfaction of a debt previously contracted under Sec. 225.12(b); (ii) stands only in the position of a creditor and does not purchase equity of obligors of debt in default (other than equity that may be collateral for such debt); and (iii) does not acquire debt in default secured by shares of a bank or bank holding company.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(2)(vii)
Debt previously contracted. Holding shares in satisfaction of a debt previously contracted, as described more fully in the BHC Act.	BHCA Section 4(c)(2)
Disease management. The Federal Reserve Board has taken the position that engaging in disease management is a complementary activity to insurance underwriting and selling health insurance, subject to certain restrictions.	BHCA Section 4(k)(1)(B); Federal Reserve Bulletin, December 2007, Legal Developments: Third Quarter, 2007, FRB Order dated September 7, 2007
Education. Providing educational courses, and instructional materials to consumers on individual financial management matters.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(6)(v)
Employee benefits and plans. Providing consulting services to employee benefit, compensation and insurance plans, including designing plans, assisting in the implementation of plans, providing administrative services to plans, and developing employee communication programs for plans.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(9)(ii)
Export trading companies. Certain acquisitions of shares of any company which is an export trading company, as described in more detail in section 4(c)(14) of the BHC Act.	BHCA Section 4(c)(14)
Fiduciary activities. Holding shares acquired in a fiduciary capacity, as more fully described in the BHC Act.	BHCA Section 4(c)(4)

Fiduciary services. Performing functions or activities that may be performed by a trust company (including activities of a fiduciary, agency, or custodial nature), in the manner authorized by federal or state law, as more fully described in the Federal Reserve Board's regulations.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR 225.28(b)(5)
Finder services. Acting as a finder in bringing together one or more buyers and sellers of any product or service for transactions that the parties themselves negotiate and consummate. See 12 CFR § 225.86(d)(1) for additional information and examples.	BHCA Section 4(k)(1)(A); 12 CFR § 225.86(d)(1)
Foreign exchange. Engaging as principal in foreign exchange transactions.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(8)(ii)(A)
Foreign exchange and commodities. Providing information, statistical forecasting, and advice with respect to any transaction in foreign exchange, swaps, and similar transactions, commodities, and any forward contract, option, future, option on a future, and similar instruments.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(6)(iv)
FSLIC-approved activities. Any services or activities approved by order of the former Federal Savings and Loan Insurance Corporation prior to March 5, 1987, pursuant to its authority under section 408(c)(2)(F) of the National Housing Act, as in effect at the time.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(12)
Futures commission merchant. Acting as a futures commission merchant (FCM) for unaffiliated persons in the execution, clearance, or execution and clearance of any futures contract and option on a futures contract traded on an exchange in the United States or abroad if: (i) the activity is conducted through a separately incorporated subsidiary of the bank holding company, which may engage in activities other than FCM activities (including, but not limited to, permissible advisory and trading activities); and (ii) the parent holding company does not provide a guarantee or otherwise become liable to the exchange or clearing association other than for those trades conducted by the subsidiary for its own account or for the account of any affiliate.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(7)(iv)
Industrial banking. Owning, controlling, or operating an industrial bank, Morris Plan bank, or industrial loan company, so long as the institution is not a bank.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(4)(i)

Information services. Furnishing general economic information and advice, general economic statistical forecasting services, and industry studies.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(6)(ii)
Information dissemination. Providing employment histories to third parties for use in making credit decisions and to depository institutions and their affiliates for use in the ordinary course of business.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.86(a)(2)(iv)
Insurance. Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State.	BHCA Section 4(k)(4)(B)
Insurance. Supervising on behalf of insurance underwriters the activities of retail insurance agents who sell: (i) fidelity insurance and property and casualty insurance on the real and personal property used in the operations of the bank holding company or its subsidiaries; and (ii) group insurance that protects the employees of the bank holding company or its subsidiaries.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(11)(v)
Insurance agency or escrow business.	HOLA Section 10(c)(2)(B)
Insurance agency. Acting as agent or broker for insurance directly related to an extension of credit by a finance company (as defined in the Federal Reserve Board's regulations) that is a subsidiary of a savings and loan holding company, if: (i) the insurance is limited to ensuring repayment of the outstanding balance on such extension of credit in the event of loss or damage to any property used as collateral for the extension of credit; and (ii) the extension of credit is not more than $10,000, or $25,000 if it is to finance the purchase of a residential manufactured home[1] and the credit is secured by the home; and (iii) the applicant commits to notify borrowers in writing that they are not required to purchase such insurance from the applicant, such insurance does not insure any interest of the borrower in the collateral; and the applicant will accept more comprehensive property insurance in place of such single-interest insurance.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(11)(ii)

[1] These limitations increase at the end of each calendar year, beginning with 1982, by the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

Insurance agency. Engaging in any insurance agency activity in a place where the holding company or a subsidiary of the holding company has a lending office and that: (i) has a population not exceeding 5,000 (as shown in the preceding decennial census); or (ii) has inadequate insurance agency facilities, as determined after notice and opportunity for hearing.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(11)(iii)
Insurance agency. Engaging in any insurance-agency activity if the holding company has total consolidated assets of $50 million or less. A holding company performing insurance-agency activities under this paragraph may not engage in the sale of life insurance or annuities except as provided in 12 CFR § 225.28(b)(11)(i) and (iii), and it may not continue to engage in insurance-agency activities pursuant to this provision more than 90 days after the end of the quarterly reporting period in which total assets of the holding company and its subsidiaries exceed $50 million.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(11)(vi)
Insurance company investments. Directly or indirectly acquiring or controlling, whether as principal, on behalf of 1 or more entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls) or otherwise, shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section if: (i) the shares, assets, or ownership interests are not acquired or held by a depository institution or a subsidiary of a depository institution; (ii) such shares, assets, or ownership interests are acquired and held by an insurance company that is predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit-related insurance) or providing and issuing annuities; (iii) such shares, assets, or ownership interests represent an investment made in the ordinary course of business of such insurance company in accordance with relevant State law governing such investments; and (iv) during the period such shares, assets, or ownership interests are held, the bank holding company does not routinely manage or operate such company except as may be necessary or required to obtain a reasonable return on investment.	BHCA Section 4(k)(4)(I)

Insurance underwriting. Underwriting or reinsuring contract of credit life or credit health and accident insurance in connection with extensions of credit by the savings and loan holding company or any of its subsidiaries, or extensions of credit by any savings association or service corporation subsidiary thereof, or any other savings and loan holding company or subsidiary thereof.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(9)
Intermediary activities. Acting as intermediary for the financing of commercial or industrial income-producing real estate by arranging for the transfer of the title, control, and risk of such a real estate project to one or more investors, if the bank holding company and its affiliates do not have an interest in, or participate in managing or developing, a real estate project for which it arranges equity financing, and do not promote or sponsor the development of the property.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(ii)
Investment Advisor. Serving as investment adviser (as defined in § 2(a)(20) of the Investment Company Act of 1940, 15 USC § 80a-2(a)(20)), to an investment company registered under that act, including sponsoring, organizing, and managing a closed-end investment company.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(6)(i)
Investment banking related activities. Providing advice in connection with mergers, acquisitions, divestitures, investments, joint ventures, leveraged buyouts, recapitalizations, capital structurings, financing transactions and similar transactions, and conducting financial feasibility studies.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(6)(iii)
Investment company holdings. Holding shares of an investment company which is not a bank holding company and which is not engaged in any business other than investing in securities, which securities do not include more than five percent of the voting shares of any company.	BHCA Section 4(c)(7)
Leasing personal or real property. Leasing personal or real property or acting as agent, broker, or adviser in leasing such property if: (i) the lease is on a nonoperating basis, as more fully described in the Federal Reserve Board's regulations; (ii) the initial term of the lease is at least 90 days; and (iii) in the case of leases involving real property, other conditions are met.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(3)
Lending and safeguarding. Lending, exchanging, transferring, investing for others, or safeguarding money or securities.	BHCA Section 4(k)(4)(A)

Lending. Originating, purchasing, selling and servicing of loans, and participation interests in loans, secured by real estate, including brokerage and warehousing of such real estate loans, except that such a company or subsidiary may not invest in a loan secured by real estate as to which a subsidiary savings association of such company has a security interest.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(1)(i)
Lending. Originating, purchasing, selling and servicing of manufactured home chattel paper, including brokerage and warehousing of such chattel paper.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(1)(ii)
Lending. Originating, purchasing, selling and servicing of loans, with or without security, for the altering, repairing, improving, equipping or furnishing of any residential real estate.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(1)(iii)
Lending. Originating, purchasing, selling and servicing of educational loans.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(1)(iv)
Lending. Originating, purchasing, selling and servicing of consumer loans, as defined in 12 CFR § 560.3, provided that no subsidiary savings association of such holding company or service corporation of such savings association may engage directly or indirectly, in any transaction with any affiliate involving the purchase or sale, in whole or in part, of any consumer loan.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(1)(v)
Lending. Making, acquiring, brokering, or servicing loans or other extensions of credit (including factoring, issuing letters of credit and accepting drafts) for the company's account or for the account of others.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(1).
Liquidation activities. Liquidating assets acquired from such savings and loan holding company or its thrift subsidiaries.	BHCA Section 4(c)(1)(D)

Management consulting. Providing management consulting advice on any matter to unaffiliated depository institutions, including commercial banks, savings and loan associations, savings banks, credit unions, industrial banks, Morris Plan banks, cooperative banks, industrial loan companies, trust companies, and branches or agencies of foreign banks. [2] (Subject to 12 CFR § 225.28(b)(9)(i)(B) restrictions.)	BHCA Sections 4(k)(4)(F) and 10(c)(8); 12 CFR § 225.28(b)(9)(i)(A)(*1*)
Management consulting. Providing management consulting on any financial, economic, accounting, or audit matter to any other company.[3] (Subject to 12 CFR § 225.28(b)(9)(i)(B) restrictions.)	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(9)(i)(A) (*2*)
Management consulting - other. A company conducting management consulting activities may provide management consulting services to customers not described in the two previous rows, if the total annual revenue derived from those management consulting services does not exceed 30 percent of the company's total annual revenue derived from management consulting activities.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(9)(i)(C)
Management consulting. Providing management consulting services, including to any person with respect to nonfinancial matters, so long as the management consulting services are advisory and do not allow the financial holding company to control the person to which the services are provided.	BHCA Section 4(k)(4)(G); 12 CFR § 225.86(b)(1)
Management services. Furnishing or performing management services for a savings association subsidiary of such company.	HOLA Section 10(c)(2)(A)
Metals trading and related activities. Buying and selling bullion, and related activities. Buying, selling and storing bars, rounds, bullion, and coins of gold, silver, platinum, palladium, copper, and any other metal approved by the Board, for the company's own account and the account of others, and providing incidental services such as arranging for storage, safe custody, assaying, and shipment.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(8)(iii)

[2] In performing this activity, bank holding companies are not authorized to perform tasks or operations or provide services to client institutions either on a daily or continuing basis, except as necessary to instruct the client institution on how to perform such services for itself. See also the Board's interpretation of bank management consulting advice (12 CFR § 225.131).

[3] Id.

Merchant banking/Investment banking. Directly or indirectly acquiring or controlling, whether as principal, on behalf of 1 or more entities (including entities, other than a depository institution or subsidiary of a depository institution, that the bank holding company controls), or otherwise, shares, assets, or ownership interests (including debt or equity securities, partnership interests, trust certificates, or other instruments representing ownership) of a company or other entity, whether or not constituting control of such company or entity, engaged in any activity not authorized pursuant to this section if: (i) the shares, assets, or ownership interests are not acquired or held by a depository institution or subsidiary of a depository institution; (ii) such shares, assets, or ownership interests are acquired and held by: (A) a securities affiliate or an affiliate thereof; or (B) an affiliate of an insurance company described in subparagraph (I)(ii) that provides investment advice to an insurance company and is registered pursuant to the Investment Advisers Act of 1940 (15 USC 80b-1 et seq.), or an affiliate of such investment adviser, as part of a *bona fide* underwriting or merchant or investment banking activity, including investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment; (iii) such shares, assets, or ownership interests are held for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the activities described in clause (ii); and (iv) during the period such shares, assets, or ownership interests are held, the bank holding company does not routinely manage or operate such company or entity except as may be necessary or required to obtain a reasonable return on investment upon resale or disposition.	BHCA Section 4(k)(4)(H)
Money orders. The issuance and sale at retail of money orders and similar consumer-type payment instruments.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(13)
Mutual funds. Organizing, sponsoring, and managing a mutual fund, provided that (i) the fund does not exercise managerial control over the entities in which the fund invests; and (ii) the holding company reduces its ownership in the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund or such additional period as the permitted.	BHCA Section 4(k)(4)(G); 12 CFR § 225.86(b)(3)
Mutual fund services. Providing administrative and other services to mutual funds.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.86(a)(2)(i)

National bank activities. Holding shares of the kinds and amounts eligible for investment by national banks under the provisions of 12 USC § 24.	BHCA Section 4(c)(5)
Notary public services. Notary public services, in connection with offering banking services.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.86(a)(2)(vi)
Options and futures. Engaging as principal in forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset (including gold, silver, platinum, palladium, copper, or any other metal approved by the Board), nonfinancial asset, or group of assets, other than a bank-ineligible security,[4] if certain conditions are met.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(8)(ii)(B) (including requirements therein)
Options and futures. Engaging as principal in forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on an index of a rate, a price, or the value of any financial asset, nonfinancial asset, or group of assets, if the contract requires cash settlement, as described in greater detail in the Federal Reserve Board's regulations.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(8)(ii)(C)
Personnel benefit plans. A savings and loan holding company may develop and administer personnel benefit programs, including life insurance, health insurance, and pension or retirement plans, primarily for affiliates and for savings association subsidiaries, or for multiple savings and loan holding companies and affiliates thereof.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(3)(iii)
Pharmacy. The Federal Reserve Board has taken the position that engaging in the mail order pharmacy business is a complementary activity to insurance underwriting and selling health insurance, subject to certain restrictions.	BHCA Section 4(k)(1)(B); See Federal Reserve Bulletin, December 2007, Legal Developments: Third Quarter, 2007, FRB Order dated September 7, 2007
Postage stamp sales. Sales of postage stamps and postage-paid envelopes, in connection with offering banking services,	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.86(a)(2)(vi)

[4] A bank-ineligible security is any security that a state member bank is not permitted to underwrite or deal in under 12 USC §§ 24 and 335.

Printing. Printing and selling MICR-encoded items. Printing and selling checks and related documents, including corporate image checks, cash tickets, voucher checks, deposit slips, savings withdrawal packages, and other forms that require Magnetic Ink Character Recognition encoding.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(10)(ii)
Private placement services. Acting as agent for the private placement of securities in accordance with the requirements of the Securities Act of 1933 and the rules of the Securities and Exchange Commission, if the company engaged in the activity does not purchase or repurchase for its own account the securities being placed, or hold in inventory unsold portions of issues of these securities.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(7)(iii)
Property management. Holding or managing properties used or occupied by a savings association subsidiary of such company.	HOLA Section 10(c)(2)(D)
Property management. Holding or operating properties used wholly or substantially by any savings association subsidiary of such holding company in the operations of such subsidiary or acquired for such future use.	BHCA Section 4(c)(1)(A)
Purchasing. A savings and loan holding company may purchase office supplies, furniture and equipment primarily for affiliates and for savings association subsidiaries, or for multiple savings and loan holding companies and affiliates thereof.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(3)(v)
Qualified Stock Issuance. In the case of a savings and loan holding company, purchasing, holding, or disposing of stock acquired in connection with a qualified stock issuance if the purchase of such stock by such savings and loan holding company is approved by the Director pursuant to subsection (q)(1)(D) of section 10 of the HOLA.	HOLA Section 10(c)(2)(G)
Real estate acquisition. Acquisition of unimproved real estate lots, and acquisition of other unimproved real estate for the purpose of prompt development and subdivision, for (i) construction of improvements, (ii) resale to others for such construction, or (iii) use as mobile home sites.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(4)
Real estate development. Development, subdivision and construction of improvements on real estate acquired pursuant to sec. 584.2-1(b)(4), for sale or rental.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(5)

Real estate improvement. Acquisition of improved real estate for remodeling, rehabilitation, modernization, renovation, or demolition and rebuilding for sale or for rental.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(7)
Real estate maintenance and management. Management and maintenance of improved real estate.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(8)
Real estate rental. Acquisition of improved real estate and mobile homes to be held for rental.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(6)
Real estate title abstracting.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.86(a)(2)(vii)
Real estate settlement services. Providing real estate settlement services.[5]	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(2)(viii)
Research, studies, and surveys. A savings and loan holding company may conduct research studies and surveys primarily for affiliates and for savings association subsidiaries, or for multiple savings and loan holding companies and affiliates thereof.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(3)(iv)
Riskless principal transactions. Buying and selling in the secondary market all types of securities on the order of customers as a "riskless principal" to the extent of engaging in a transaction in which the company, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security for its own account to offset a contemporaneous sale to (or purchase from) the customer. This does <u>not</u> include selling bank-ineligible securities[6] at the order of a customer that is the issuer of the securities, or selling bank-ineligible securities in any transaction where the company has a contractual agreement to place the securities as agent of the issuer; or acting as a riskless principal in any transaction involving a bank-ineligible security for which the company or any of its affiliates acts as underwriter (during the period of the underwriting or for 30 days thereafter) or dealer.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(7)(ii)
Safe deposit business.	BHCA Section 4(c)(1)(B)

[5] For purposes of this section, real estate settlement services do not include providing title insurance as principal, agent, or broker.
[6] A bank-ineligible security is any security that a State member bank is not permitted to underwrite or deal in under 12 USC §§ 24 and 335.

Savings Bonds. The sale of U.S. savings bonds.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(13)
Securities brokerage or underwriting. Underwriting, dealing in, or making a market in securities.	BHCA Section 4(k)(4)(E)
Securities brokerage. Providing securities brokerage services (including securities clearing and/or securities execution services on an exchange), whether alone or in combination with investment advisory services, and incidental activities (including related securities credit activities and custodial services), if the securities brokerage services are restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting or dealing.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(7)(i)
Securities Exchange. Owning shares of a securities exchange.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.86(a)(2)(ii)
Services. Furnishing services to or performing services for such savings and loan holding company or its thrift subsidiaries.	BHCA Section 4(c)(1)(C)
Share ownership. Holding shares acquired from a subsidiary that has been requested by any federal or state authority to dispose of such shares, provided that such shares must be disposed within a two-year period.	BHCA Section 4(c)(3)
Share ownership. Holding shares of any company that do not include more than five percent of the outstanding voting shares of such company.	BHCA Section 4(c)(6) [7]
Share ownership. Shares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Federal Reserve Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of the statute and would be in the public interest. The Federal Reserve Board has implemented this provision through the qualifying foreign banking organization provisions of 12 CFR § 211.23.	BHCA Section 4(c)(9).

[7] Note that OTS' position under the HOLA is that holdings of less than ten percent of the voting stock of a company do not cause the savings and loan holding company to be engaged in the activities of such company.

Share ownership. Shares of, or activities conducted by, any company which does no business in the United States except as an incident to its international or foreign business, if the Federal Reserve Board, by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of the statute and would be in the public interest. See 12 CFR § 211.602.	BHCA Section 4(c)(13).
Storage facilities. A savings and loan holding company may develop and operate storage facilities for microfilm or other duplicate records primarily for affiliates and for savings association subsidiaries, or for multiple savings and loan holding companies and affiliates thereof.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(3)(vi)
Tax planning and preparation. Providing tax planning and tax preparation services to any person.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(6)(vi)
Tax preparation services. Preparation of state and Federal tax returns for accountholders of or borrowers from (including immediate family members of such accountholders or borrowers but not including an accountholder or borrower which is a corporation operated for profit) an affiliated savings association.	HOLA Section 10(c)(2)(F)(ii); 12 CFR § 584.2-1(b)(10)
Tickets. Selling public transportation tickets and tokens, in connection with offering banking services.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.86(a)(2)(vi)
Travel agency. Operating a travel agency in connection with financial services offered by the financial holding company or others.	BHCA Section 4(k)(4)(G); 12 CFR § 225.86(b)(2)
Travelers checks. Issuance and sale of traveler's checks.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR 225.28(b)(13)
Trustee. Acting as trustee under deed of trust.	HOLA Section 10(c)(2)(E)

Underwriting and dealing in government obligations and money market instruments. Underwriting and dealing in obligations of the United States, general obligations of states and their political subdivisions, and other obligations that state member banks of the Federal Reserve System may be authorized to underwrite and deal in under 12 USC §§ 24 and 335, including banker's acceptances and certificates of deposit, under the same limitations as would be applicable if the activity were performed by a bank holding company's subsidiary member banks or its subsidiary nonmember banks as if they were member banks.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.28(b)(8)(i)
Vehicle registration services. Vehicle registration services, in connection with offering banking services.	BHCA Sections 4(k)(4)(F) and 4(c)(8); 12 CFR § 225.86(a)(2)(vi)

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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.

[3] See 26 CFR 1.1502–77(a).

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

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

In the Risk Management component of the holding company examination, you should evaluate the ability of the holding company enterprise to identify, measure, monitor, and control risk. The complexity of risk management will vary based on the size and complexity of the holding company's operations. Noncomplex holding companies may have minimal risk management programs or rely on the thrift subsidiary's risk management system. Complex and conglomerate holding companies should adopt formal risk management systems commensurate with their risk level. The most complex firms should implement enterprise-wide risk management programs. In your assessment of risk management, you should consider four elements:

- Governance/board and senior management oversight;
- Policies, procedures, and limits;
- Risk monitoring and management information systems; and
- Internal controls.

You should rely on the conclusions you reached regarding the holding company enterprise's risk profile in the Organizational Structure section as a foundation for assessing these elements and analyzing the enterprise's control environment.

You should rely on the conclusions you reached regarding the holding company enterprise's risk profile in the Organizational Structure section as a foundation for assessing these elements and analyzing the enterprise's control environment. You should risk-focus your review on key business lines, legal entities, or strategic plans. The Risk Management component underscores the importance of the control environment, considering the complexity of the enterprise and the inherent risk in its activities. Examples of events that can alter the risk profile of a holding company enterprise include:

- Entering into new activities, markets, or business lines;
- Failing to implement policies and procedures to manage risks appropriately;
- Engaging in potentially abusive transactions with insiders or other affiliates;
- Incurring significant debt;
- Issuing trust preferred or other hybrid securities without a plan to deploy the proceeds; or

- Growing without adequate capital support.

Strong risk management is important because risk exposures are dynamic. Even lower-risk activities or investments can adversely affect the holding company enterprise when mismanaged. You should ensure that management does not deviate from established risk management standards to fulfill short-term objectives. Losses or lower than anticipated returns can result in the holding company exerting undue pressure on affiliates, including the thrift, to meet its other obligations. Such pressures can result in inadequate oversight or inappropriate actions with regard to the best interests of the holding company enterprise.

Your evaluation of the four risk management areas will provide a consistent framework for drawing conclusions about risk management and the control environment in complex firms. Moreover, a consistent review of these four areas provides a clear structure and basis for rating and discussing the Risk Management component. The following table describes the four risk management elements:

RISK MANAGEMENT ELEMENT	DESCRIPTION
Governance/Board and Senior Management Oversight	This area evaluates the adequacy and effectiveness of board and senior management's understanding and management of risk inherent in the holding company enterprise's activities, as well as the general capabilities of management. It also considers management's ability to identify, understand, and control the risks within the holding company enterprise, to hire competent staff, and to respond to changes in risk profile or changes in the holding company's operating sectors.
Policies, Procedures, and Limits	This area evaluates the adequacy of policies, procedures, and limits given the risks inherent in the activities of the consolidated enterprise and its stated goals and objectives. OTS's analysis considers the adequacy of the enterprise's accounting and risk disclosure policies and procedures.
Risk Monitoring and Management Information Systems	This area assesses the adequacy of risk measurement and monitoring, and the adequacy of the holding company's management reports and information systems. Include a review of the assumptions, data, and procedures used to measure risk and the consistency of these tools with the level of complexity of the enterprise's activities.
Internal Controls	This area evaluates the adequacy of internal controls and internal audit procedures, including the accuracy of financial reporting and disclosure and the strength and influence of the internal audit team. Include a review of the independence of control areas from management and the consistency of the scope coverage of the internal audit team with the complexity of the enterprise.

In addition to those four elements, reinsurance is a key risk management element for insurance companies. Insurance companies will purchase reinsurance to transfer risk. It provides a means to transfer risk for specific lines of business or geographic territories to provide catastrophe protection or to stabilize or reduce volatility in underwriting results. Section 930 of the Holding Companies Handbook describes the supervision of insurance companies that are thrift holding companies. Please review section 930 for additional information on the unique requirements of conducting a holding company examination of an insurance company.

GOVERNANCE/BOARD AND SENIOR MANAGEMENT OVERSIGHT

Reviewing corporate governance is an essential component of the risk management review. Corporate governance includes the processes, customs, and standards through which directors and managers in an enterprise conduct activities. Your review of corporate governance will vary based on the size and complexity of the holding company. Noncomplex holding companies will rely heavily on the corporate governance standards of the thrift subsidiary, whereas complex and conglomerate holding companies must adhere to standards that are more detailed. In 2002, the U.S. government passed the Sarbanes-Oxley Act, which mandates a range of standards to ensure corporate responsibility, prevent conflicts of interest, and improve financial disclosures in public companies. This law and resulting regulations impose strong standards on the conduct of the board and senior management.

> Your review of corporate governance will vary based on the size and complexity of the holding company.

The board and senior management review is an important aspect of the examination of corporate governance. OTS evaluates the board of directors and senior management of the holding company enterprise based on how their actions affect the holding company, its affiliates, and the thrift subsidiary. The evaluation considers management and the board's competence, integrity, and risk sensitivity. Your examination of risk management should assess management and the board's ability and willingness to manage risk appropriately. Management and the board of a noncomplex holding company that does not engage in any significant activities other than owning the thrift are often identical to that of the thrift subsidiary and do not require in-depth review. In these types of structures, you should apply the findings of the management review during the thrift examination to your conclusions in the holding company examination.

Board of Directors[1]

Holding company directors should fulfill their legal and fiduciary responsibilities and bring functional expertise to the holding company enterprise. The board must control and govern the affairs of the

[1] OTS developed the "*Directors' Responsibilities Guide*" and "*Directors' Guide to Management Reports*", which are available on the OTS website (www.ots.treas.gov). OTS designed the guides to apply to thrift directors, however they provide a wealth of information, including references to other publications regarding director responsibilities. In addition, Section 310 of the Examination Handbook provides information on the oversight role of thrift directors.

holding company by maintaining a working knowledge of inherent risks, risk management standards, and key holding company operations. 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 the holding company and its affiliates.

The board of directors or a designated committee of the board has multiple responsibilities, including:

- Selecting and retaining competent management and reviewing its performance;
- Monitoring and assessing the enterprise's activities;
- Approving overall business strategies;
- Conducting affairs ethically and avoiding the appearance of conflicts of interest;
- Approving policies that clearly articulate risk tolerances and limits; and
- Periodically reviewing and reevaluating the business plan, strategies, and risk management policies and procedures of the holding company enterprise, material subsidiaries, and key business lines.

> The board must control and govern the affairs of the holding company by maintaining a working knowledge of inherent risks, risk management standards, and key holding company operations.

Your examination of the holding company enterprise's board of directors should include assessing changes in board composition, reviewing board minutes, identifying and assessing key board committees, and reviewing board reports to determine if the board obtains timely, accurate, and detailed information to fulfill its responsibilities.

Management

Holding company management is responsible for implementing the board's strategies and adhering to its risk limits. The ability of senior management to enact the enterprise's business plan affects the long-term viability of the holding company enterprise and its subsidiaries and affiliates. Because of this, you should perform a focused review of management. While the board is responsible for selecting, reviewing, and compensating senior management, senior management is responsible for operating the company under the parameters the board establishes. Management should run day-to-day operations, ensure the board receives timely and accurate information, and provide advice regarding business strategies. You should expand the scope of your review of management when:

- Unusual turnover of senior management occurs;
- Management accepts high risks without implementing compensating controls;

- A major portion of management's compensation derives 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;
- There is evidence that management does not adhere to board standards or limits; or
- A contest for control of the company is likely.

Key senior management functions include:

- Providing the board with information and advice for strategic planning;
- Managing the company's activities and implementing long-range plans to meet the board's goals;
- Adhering to, enforcing, and monitoring compliance with policies and operating procedures;
- Establishing and ensuring effective internal controls, books, records, and systems that maintain appropriate risk management standards;
- Ensuring the enterprise hires and retains staff with sufficient expertise, integrity, and ethics; and
- Evaluating the enterprise's performance and analyzing and managing changes in risk exposure.

You should identify any changes in key managers and their areas of responsibility since the previous examination by reviewing H-(b)11 reports, public filings, or organizational charts. You can also determine if management responsibilities have changed through discussions with management. Once you identify changes to key officials and their responsibilities, you can consider their qualifications and assess management's overall effectiveness.

Corporate Governance and the Thrift Subsidiary

A weak or ineffective board of directors or management team can fail to identify and address problems within the holding company enterprise that can adversely affect the thrift. It is important to assess the holding company's strategies and plans for the thrift subsidiary. You should also review the involvement level of holding company management in thrift operations to ensure it is not detrimental to the insured subsidiary. Effective risk management requires active management of any company by its directorate and senior management. You should ensure that the involvement by the parent holding company does not impair the thrift's board and management from fulfilling its responsibilities.

In many cases, management of the holding company and the thrift overlap or are similar. While there are regulatory restrictions (and conditions of approval that OTS imposes at 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 when the board members or management personnel are similar, their roles and responsibilities with respect to the holding company will differ from the thrift. You should identify potential or perceived conflicts of interest for review. Directors, officers, and employees of a thrift owe a fiduciary duty to the thrift and must not advance their 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 of the thrift, all directors and officers should avoid using this influence to advance their personal interests at the expense of the thrift.

Some holding companies acquire thrifts as passive investments, while others plan to manage the financial institutions proactively. The materiality of the thrift operations will affect how active holding company management is in decisions that affect the thrift. Significant indicators of materiality include the asset size and proportion of income the thrift contributes within the enterprise. Strategic plans that involve the thrift can also indicate that the thrift is a material entity in the organization even when it remains a small proportion of total assets or income. A holding company with a substantial investment in a thrift is more likely to exercise significant influence over the thrift operations. Holding companies that passively invest may only monitor performance as long as the thrift provides a reasonable rate of return for their investment. These same holding companies may also take a more aggressive management posture when thrift performance does not meet expectations. Using your judgment, you should assess the materiality of the thrift to the holding company operations and determine if there are any factors leading to above average involvement from the holding company. As a portion of your risk management conclusion, you should assess the holding company's effect on the thrift subsidiary.

Policies, Procedures, and Limits

Holding companies, particularly diversified holding companies, are involved in a wide range of different businesses. These companies should maintain enterprise-wide, written policies and procedures that outline their approach to risk management. Holding company management should ensure that policies are in place to prevent practices that put the enterprise, including the thrift subsidiary, at unacceptable risk. Policies should cover all material internal controls areas and standards for operation. It is acceptable for noncomplex holding companies to adopt the policies and limits of the thrift subsidiary.

Examiners should 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 enterprise, including the thrift subsidiary. Based on the inherent risks and structure you identified in the Organizational Structure section, assess whether management has adhered to the established policies, procedures, and limits of the board of directors. You should assess the effectiveness of the policies in managing risk and determine if revisions are necessary based on changes in the enterprise's risk profile.

Risk limits are a necessary component of an effective risk management program. You should identify board-approved risk limits and ensure that senior management adopts, communicates, and monitors

[2] See 12 CFR 563.33.

operations to ensure compliance with those limits. You should verify that the risk limits are commensurate with the goals and objectives of the enterprise as well as its financial strength and staff expertise. Senior management and the board should design their risk management structure to identify and correct violations of approved limits. When you note risk limit violations, you should notify senior management and recommend corrective action.

Board risk limits should be a quantitative method for measuring the enterprise's tolerance for risk exposure. The board can express limits in absolute dollar amounts or relative percentages. In many cases, risk limits include prohibitions on specific business activities or investments. Some examples of common risk limits include:

- Size limits for specific balance sheet portfolios (i.e. loans, securities, derivatives);
- Interest rate risk exposure limits;
- Limits on geographic, counterparty, or other concentrations; or
- Capital adequacy thresholds.

Risk Monitoring and Management Information Systems

Routine and effective risk monitoring relies on management and the board identifying the holding company enterprise's material risk exposures. They must then develop tools and information systems to monitor and analyze those exposures. Management information systems (MIS) are important throughout an organization. MIS include the policies, procedures, reports, and controls that management and the board implement to manage and monitor risk. MIS can include tools that management and the board use to make risk management decisions ranging from simple credit decisions to sophisticated capital management decisions.

The sophistication and use of risk monitoring programs and MIS varies based on the size and complexity of the enterprise. In complex holding companies, line managers use MIS in day-to-day operations to manage risk and implement business activities. The board and senior management use MIS to manage risk, monitor business activities, and make strategic decisions. In noncomplex holding companies, MIS are basic or, in many cases, the holding company relies on thrift systems and procedures to support its limited activities. Examples of key areas where holding companies rely on MIS include:

- Monitoring aggregate risk concentration by industry, geography, customer, etc.
- Analyzing credit risk, including portfolio composition, credit analysis, delinquency trends, etc.
- Establishing and monitoring the enterprise's budget and business plan.
- Monitoring and managing interest rate risk.

- Analyzing capital levels with economic capital models.

MIS should be sufficient for management to identify, monitor, and manage the risk exposures of the holding company enterprise while enabling it to meet its business objectives. Material changes in size, scope, or risk level of operations should result in adjustments to MIS, and management should periodically review its systems to ensure they match and support the complexity of operations. It is imperative that MIS are accurate and timely.

Because MIS will vary significantly based on the size and complexity of operations, you must use your judgment to determine if the systems are adequate. Based on your assessment of inherent risks from the Organizational Structure section, you should identify one or more key business lines or areas of operation for review. You should review the holding company's monitoring reports and MIS in this area to determine if management and the board obtain informative, timely, and accurate information. You should review the data, assumptions, and procedures that the enterprise uses to develop the reports to ensure they are accurate and consistent. You should also verify that the reports appropriately convey the level of risk to their intended audience. For complex, quantitative, or technical issues, adequate MIS should summarize the issue in terms that an individual without specialized or technical knowledge can understand. Weaknesses in any stage of the development, communication, or use of MIS can result in poor business decisions.

Internal Controls

Internal controls are a critical element of a thrift holding company's risk management program. 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. Internal controls will vary based on the size, type, organizational structure, and complexity of the company. As a company grows in size and complexity, the systems and depth of the staff should also expand appropriately.

> 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.

Internal controls and accounting systems should include a mechanism to ensure regulatory compliance. Procedures should exist to both avoid and correct violations. You should identify areas of weakness in internal controls, accounting systems, and records. You should then determine the possible effect of such weakness on the holding company enterprise, including 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 results in litigation. Such litigation has monetary costs and often hurts the enterprise's reputation as well.

Internal Audit

A holding company should develop an internal audit program commensurate with its size and complexity. It should structure the audit program to confirm that the holding company enterprise complies with its policies and procedures and that it does not violate any laws, rules, or regulations. You should review the audit program to ensure that it assesses the risk in the entire enterprise and focuses appropriate resources on higher-risk areas of review. You should also determine whether there are appropriate management information systems to track, monitor, and resolve outstanding audit concerns. A noncomplex holding company will not have an audit department, but should rely on the thrift institution's audit review of its activities, including intercompany transactions and tax sharing agreements.

The internal audit staff should be independent. It should have or acquire the necessary expertise and resources to audit each business activity of the enterprise. The audit should have a defined schedule that incorporates reviews of all material risk areas on a routine basis. The internal audit staff should report material findings to the board or its audit committee. Your review should assess the accuracy, adequacy, and independence of the audit department's assessment, planning, auditing, reporting, and monitoring functions.

Holding companies whose subsidiary thrift(s) have consolidated aggregate assets of $500 million or greater must obtain an independent audit.[3] An independent public accountant that satisfies the qualifications outlined in 12 CFR 562.4(d), including the independence requirements and interpretations of the Securities and Exchange Commission, must perform the audit. Examination Handbook Section 350, External Audit, outlines the specific guidelines for OTS-required audits.

Rating The Risk Management Component

The Risk Management rating is an assessment of the effectiveness of the holding company's board and senior management; policies, procedures, and limits; risk monitoring and management information systems; and internal controls. 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; and
- Dependency, indicated by the ability of the holding company to operate independently of the thrift and vice versa.

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

Risk Management Rating 1. A rating of 1 indicates that management effectively identifies and controls all major enterprise risks. Management is fully prepared to address risks emanating from new products and changing market conditions. The board and management are forward-looking and active participants in managing risk. Management ensures that appropriate policies and limits exist and that the board understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide management and the board with the information and analysis necessary to make timely and appropriate decisions in response to changing conditions. Risk management practices and the enterprise's infrastructure are flexible and highly responsive to changing industry practices and current regulatory guidance. Staff has sufficient expertise and depth to manage the risks assumed. Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the holding company. There are few noted exceptions to the enterprise's established policies and procedures, and none is material. Management effectively and accurately monitors and manages the enterprise consistent with applicable laws, regulations, and guidance, and in accordance with internal policies and procedures. Risk management processes are fully effective in identifying, monitoring, and controlling risks.

Risk Management Rating 2. A rating of 2 indicates that the enterprise's management of risk is largely effective, but exhibits some minor weaknesses. Management and the board demonstrate a responsiveness and ability to cope successfully with existing and foreseeable risks in the business plans. While the enterprise may have some minor risk management weaknesses, management and the board have recognized and are resolving these problems. Overall, board and senior management oversight, policies and limits, risk monitoring procedures, reports, and management information systems are satisfactory and effective. Risks are controlled and do not require additional supervisory attention. The holding company enterprise's risk management practices and infrastructure are satisfactory, and management makes appropriate adjustments in response to changing industry practices and current regulatory guidance. Staff expertise and depth are generally appropriate to manage the risks assumed. Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the condition of the enterprise.

Risk Management Rating 3. A rating of 3 signifies that there are moderate deficiencies in risk management practices and, therefore, there is a cause for additional supervisory attention. One or more of the four elements of sound risk management is not acceptable, which precludes the enterprise from fully addressing one or more significant risks to its operations. Certain risk management practices need improvement to ensure that management and the board are able to identify, monitor, and control all significant risks. In addition, the risk management structure may need improvement in areas of significant business activity, or staff expertise may not be commensurate with the scope and complexity of business activities. Management's response to changing industry practices and regulatory guidance may not be sufficient. The internal control system may be lacking in some important aspects, leading to continued control exceptions or failure to adhere to written policies and procedures. The risk management weaknesses could have adverse effects if management does not take corrective action.

Risk Management Rating 4. A rating of 4 represents deficient risk management practices that fail to identify, monitor, and control significant risk exposures in material respects. There is a general lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management is deficient and requires immediate and concerted corrective action by the board and management. The enterprise may have serious identified weaknesses that require substantial improvement in internal control, accounting procedures, or adherence to laws, regulations, and supervisory guidance. The risk management deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the condition of the holding company enterprise.

Risk Management Rating 5. A rating of 5 indicates a critical absence of effective risk management practices in identifying, monitoring, or controlling significant risk exposures. One or more of the four elements of sound risk management is wholly deficient, and management and the board have not demonstrated the capability to address these deficiencies. Internal controls are critically weak and could seriously jeopardize the continued viability of the enterprise. If not already evident, there is an immediate concern about the reliability of accounting records and regulatory reports and the potential for losses if corrective measures are not taken immediately. Deficiencies in the enterprise's risk management procedures and internal controls require immediate and close supervisory attention.

SUMMARY

An effective risk management program that identifies, assesses, monitors, and manages risk exposure in the holding company enterprise is essential. In order for an enterprise to develop and implement an effective program, it requires a strong board of directors that appoints and monitors a qualified senior management team. The board must establish reasonable risk tolerances and limits to match the complexity of the organization. The enterprise must develop strong risk monitoring and management information systems to verify that activities are within its risk tolerances. The risk management program should follow board-approved policies and procedures, and management should implement a robust system of internal controls, including an independent audit function.

While the complexity and structure of the holding company enterprise will affect the resulting risk management program, it is important to verify that the risk exposure levels, management and board qualifications, control structure, and management information systems are commensurate with the business activities. Noncomplex holding companies will depend more on the systems and controls of the thrift subsidiary. In your review of those entities, it is important that the activities of the holding company enterprise do not pose undue risk to the thrift and that there is clear corporate separation. You can often rely on the conclusions you reach about the thrift's risk management programs and management structure to reach your conclusions at the holding company level. Complex and conglomerate holding company enterprises should have robust risk management programs that will require a risk-focused review.

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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 consolidated entity or other affiliates within the enterprise. Senior managers frequently operate holding companies on a consolidated basis with their subsidiaries. The integration provides benefits that are key incentives for establishing a holding company structure. However, integrated operations may mean that one entity's problems become problems for other affiliated entities, including the thrift. The purpose of this Section is to assist you in evaluating the financial performance and stability of the holding company enterprise, including the potential effect on the subsidiary thrift.

You will also determine whether the holding company has sufficient sources of funds. A holding company does not have the access to insured deposits, or Federal Home Loan Bank advances, that a thrift has. While liquidity driven failures are rare among insured depository institutions, cash flow difficulties can be a primary cause for a holding company financial collapse. As a result, it is important to conduct liquidity and cash flow ratio analysis for holding company enterprises.

Risk Profile

The risk profile of a holding company enterprise is a major factor in OTS's overall evaluation. The financial condition and earnings performance of the companies in a holding company enterprise are key factors in assessing the risk profile. As a holding company or other affiliate confronts declining financial performance, it may do anything to prevent failure. Therefore, you must be attentive in situations where the risk profile of the holding company enterprise creates an incentive for the thrift or other subsidiaries to engage in riskier activities or enter into transactions that are not in their best interest.

As a holding company or other affiliate confronts declining financial performance, it may do anything to prevent failure.

The actual or pending failure of any company in the holding company enterprise may result in significant financial or operational distress for other companies in the enterprise. For example, a thrift that is 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. 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. Furthermore, companies could suffer reputational risk because of the financial condition or actions of others in the enterprise.

For 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 isolate the risk and prevent contagion.

RATIO ANALYSIS – EARLY DETECTION

Financial ratios can help you identify a financially troubled company before severe financial and legal problems surface. Ratio analysis involves two types of comparisons, trend and peer analysis. ***Trend analysis*** compares a present ratio with past or projected ratios for the same company. You can use the analysis to identify abnormalities that merit further review. The trend becomes more meaningful as the period of analysis grows. ***Peer analysis*** compares the ratios of one company with another in the same industry. It provides a benchmark for analyzing the profitability of a company with its peers. You must apply peer analysis judiciously. Holding companies are not a homogeneous group, and it is difficult to place a company into a relevant peer group. In addition, peer data may be inconsistent 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, but still be weak because the industry is in poor financial condition.

Calculate the following to assess financial performance.

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

Current Ratio: The current ratio is the proportion of current assets[1] to current liabilities[2]. As this ratio increases, the probability of failure declines because the company can convert more assets 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: The debt ratio is the ratio of total liabilities to total assets. As this ratio increases, the probability of failure increases. A high ratio indicates that the company finances larger portions of assets by contractual sources of funds that necessitate fixed charges against income.

Double Leverage Ratio: Double leverage is the ratio of thrift equity to holding company equity. This ratio increases as the holding company invests debt proceeds it obtains in the thrift as equity. The 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. Often, the parent relies on dividends from the thrift for its debt service requirements. Section 300 provides additional guidance on double leverage and how to measure it.

[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.

Return on Equity[3]: Return on equity (ROE) is the ratio of net income to investors' equity. As ROE increases, the likelihood of failure declines. Holding companies will generally evaluate profitability on a consolidated basis and will typically express it in terms of ROE. ROE identifies the percentage of earnings management has generated on the capital invested into the business.

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?
- Does the company rely on nonrecurring sources of earnings?
- 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. You should tailor the scope of your review to each organizational structure. OTS holding companies range from noncomplex entities that control only the thrift subsidiary to complex or conglomerate enterprises. Complex holding company subsidiaries may be uninsured or engage in several diverse activities, including securities broker/dealers, insurance underwriters and agents, manufacturing, and retail.

In noncomplex companies that engage in no significant activities beyond control of the thrift, thrift and holding company earnings will be almost identical, and parent-only financial statements are appropriate. In these cases, you should 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 analyze consolidated profitability levels and trends, you should obtain a consolidating worksheet that discloses and explains intercompany accounts eliminations. This will show each entity's contribution to total earnings. 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.

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

- Financial statements
- Credit ratings

[3] As with any income measure, you must look closely at ROE. You should consider the type of assets generating the profits, as well as the range of accounting assumptions. External factors are also important, including pressure from Wall Street. Finally, be aware that the ROE will increase if the company recently reduced the amount of stock outstanding through a stock buy-back.

- Stock price
- Business plans and budgets
- Intra-group transactions[4]
- Cash flow

Financial Statement Analysis

You can use internally and externally prepared financial statements, reports, and minutes to evaluate the operations of companies in a holding company enterprise. The holding company's financial statements will provide insight into the organization's overall strengths and weaknesses, as well as financial demands placed on the thrift or other regulated subsidiaries. You should also review the audit committee minutes to identify any financial recordkeeping deficiencies the independent or internal auditors disclose to the directors. You may also find information in the auditor's management letter, the internal audit reports, or correspondence with the independent auditor.

The holding company's financial statements will provide insight into the organization's overall strengths and weaknesses, as well as financial demands placed on the thrift or other regulated subsidiaries.

Financial statements and supporting schedules should be complete, consistent, and accurate. Holding companies typically retain independent accountants to provide assurance of the accuracy of their financial statements. You should carefully scrutinize unaudited financial statements or financial statements that receive a qualified audit opinion. Similarly, you should investigate significant changes in financial statements or accounting systems.

Holding companies typically prepare audited statements annually on a fully consolidated basis. You often must rely on internally prepared statements or general ledgers for interim periods. In some cases, holding companies may prepare financial statements based on the regulatory accounting principles of another industry. Thrifts in a holding company structure report basic holding company financial information on the quarterly Thrift Financial Report. You should verify the accuracy of the information on Schedule HC.

You should focus on the following areas in your review of the holding company's financial statements:

Statement of Financial Condition

Examples of steps you should take in your review of the statement of financial condition include:

- Identify high risk, cyclical or off-balance sheet activities that could adversely affect the company, causing additional pressure on other subsidiaries, including the thrift. Such activities may

[4] Refer to Organizational Structure Section 400

include 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 generate reliable cash flow. A calculation of capital that deducts these assets will provide a more realistic view of the capital position of a holding company.

- 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.

- 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

In addition to reviewing and analyzing the sources and trends of income and expenses, your review of the income statements should:

- Determine whether the business of companies within the holding company enterprise is cyclical.

- Focus on core earnings or income before extraordinary gains that are not recurring.

- Pay particular attention to securitization revenue; the accounting rules are complicated and involve some subjectivity because the calculations are assumption-driven. Unreasonable assumptions lead to misstatements of securitization gains.

Credit Ratings

You should supplement analysis of a holding company's financial statements by reviewing the credit rating of its debt. The principal rating services include Moody's Investors Services, Standard & Poors, and Fitch Investor Service, Inc. The rating provides an assessment of the perceived creditworthiness of a debtor for a specific security. A rating is not a recommendation to purchase, sell, or hold a security. Once you identify whether the rating services rated the holding company's bonds, you should determine if the ratings are subject to a downgrade.

Rating agency default studies have shown that credit ratings are an accurate predictor of defaults; that is, low-grade bonds default more frequently than high-grade securities. However, these ratings are fallible. Sudden changes in market conditions can lead to investment grade issuers filing for bankruptcy. Also, issuers with a good rating may find that their ratings decline rapidly. 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 adjusts before the rating agencies react. As a result, you should also review the market price (yield) of a holding company's debt. Bonds with low grades or high yields relative to U.S. Treasury Bonds may pose additional risks.

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

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

Identifying low-grade or declining ratings should result in an expansion of the scope of your assessment of the holding company's financial capacity and capital position.

Stock Prices

Evaluating stock price trends can provide early warning of a holding company's weakening financial condition. Stock prices reflect the perceptions of investors as they evaluate the risk profile and return 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. Higher ratios indicate 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). The market/book ratio should increase as the ROE/COE spread increases above one.

Cash Flow

Cash flow is the ability to obtain and allocate cash. Ultimately, a company's ability to generate cash flow will determine whether it will 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 or other regulated subsidiaries to service holding company debt or fulfill other obligations?
- What sources of liquidity does the holding company have?
- What are the quality and quantity of such sources?

> You can use the cash flow statement to identify and quantify the sources of funds, and to what degree the parent relies upon those funds to maintain operations.

The purpose of the cash flow statement is to summarize financing and investing activities and to identify whether the company generates funds from internal or external sources. Generally, audited financial statements provide

[5] Refer to Monitoring Section 800.

"parent company only" financial information, which includes a Statement of Cash Flows. You should use the cash flow statement for determining more than whether the company maintains positive cash flow. It can also identify how the company obtains and allocates its funds. Most importantly, you can use the cash flow statement to identify and quantify the sources of funds, and to what degree the parent relies upon those funds to maintain operations.

Subsidiaries provide funds, typically as dividends, management fees, expense reimbursements, and tax sharing payments. Ascertain the holding company's reliance on each subsidiary by considering the:

- Portion of cash flow from operating and investing activities that the subsidiary supplies; and
- Amount of interest expense on parent company borrowings that it pays from subsidiary dividends.

Concentrate on assessing or identifying any operational weaknesses that could result in the holding company requiring funding. In situations where the parent is financially distressed, determine whether the financial condition results from higher risk activities.

Cash flow or funding shortfalls can occur as a normal result of doing business. Your concern should be in determining whether shortfalls are temporary or indicate a decline in financial health. You should also determine 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.

These are temporary liquidity solutions. You should also analyze the holding company's ability to meet future and long-term cash flow needs. Selling income-generating assets will reduce future earnings, and issuing additional debt or equity will increase future funding requirements for debt service or dividend payments. While companies commonly use short-term debt to fund deficit cash flow, this practice may jeopardize their long-term liquidity and earnings by increasing liabilities and related interest costs without a corresponding increase in earning assets. If you identify and expect systemic funding imbalances 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:

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

If this ratio is below one, it is a cause for concern. A low ratio indicates that the company is not generating sufficient internal funds to cover its contractual obligations or dividends to common stockholders. Even a ratio that is only slightly greater than one may be a concern if there is a deteriorating trend. In many noncomplex holding company structures, the primary source of cash income will be dividends the thrift pays to the parent. Any dividend restrictions on the thrift will substantially affect the results of this analysis. A holding company that relies on thrift earnings and directs the thrift's operations to increase earnings can adversely affect the overall safe and sound condition of the thrift.

Liquidity

Liquidity is a company's ability to meet its short-term obligations through cash on hand, converting existing assets to cash, or rolling over maturing debt. Generally, the term short-term liquidity applies to periods of up to a year. Liquidity problems range in severity. On one hand, temporary liquidity problems may mean that a company is unable to take advantage of an immediate business opportunity. Conversely, severe liquidity shortfalls may mean that a company is unable to meet short-term obligations and may have to default on its debt obligations. As a worst case, this could result in bankruptcy.

A holding company may have loans or debts outstanding to its thrift or non-thrift subsidiaries that affect the holding company's liquidity profile. A large, negative, short-term position may result if the subsidiaries cannot readily repay these loans in the event of a liquidity shortage at the holding company. A subsidiary may be unable to repay loans or debt from its parent if it does not have adequate sources of alternative liquidity, or if the loan repayment would violate regulatory requirements or covenants between the subsidiary and other lenders. In addition, you should assess whether the holding company is using short term sources of funds such as overnight sweep deposits from customers of non-thrift subsidiaries or short term debt such as commercial paper to fund long term assets, dividends, or current expenses.

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 consider if funding is reliant upon the recovery of advances to subsidiaries, which themselves may be illiquid, and whether the company can sell assets and convert them to cash without incurring substantial loss on the sale.

If your analysis shows a material imbalance of maturing debt instruments compared to reasonably available resources, you should discuss this with management to determine how it intends to handle the shortfall. You should also incorporate this into the cash flow analysis and summarize it in the examination report.

RATING THE EARNINGS COMPONENT

The earnings rating reflects the consolidated holding company enterprise's overall financial performance and the quality of consolidated earnings profitability and liquidity. Your review of this area should consider the level, trend, and sources of earnings, as well as the ability of earnings to augment capital and provide ongoing support for an enterprise's activities.

Within this component, you should also consider the liquidity of the enterprise. This rating reflects the consolidated holding company enterprise's ability to attract and maintain the sources of funds necessary to achieve financial efficiency, support operations, and meet obligations. You should evaluate the funding conditions for each of the material legal entities in the holding company structure to determine if any weaknesses exist that could affect the funding profile of the consolidated enterprise. The earnings rating is based on the following rating definitions:

Earnings Rating 1. A rating of 1 indicates that the consolidated holding company enterprise's overall financial performance, and quantity and quality of earnings over time, are more than sufficient to make full provision for the absorption of losses and/or accretion of capital when asset quality and growth are considered. Holding company enterprises with a 1 rating also maintain strong liquidity levels and well developed funds management practices. The parent company and subsidiaries have reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

Earnings Rating 2. A rating of 2 indicates that the consolidated holding company enterprise's overall financial performance, and quantity and quality of the earnings over time, are generally adequate to make provision for the absorption of losses and/or accretion of capital when asset quality and growth are considered. These enterprises maintain satisfactory liquidity levels and funds management practices. The parent company and subsidiaries have access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses in funds management practices may be evident, but those weaknesses are correctable in the normal course of business.

Earnings Rating 3. A rating of 3 indicates that the consolidated holding company enterprise's financial performance and earnings are not fully adequate to make provisions for the absorption of losses and the accretion of capital in relation to company growth. The financial performance of enterprises rated 3 may be further clouded by static or inconsistent earnings trends, chronically insufficient earnings, or less than satisfactory asset quality. These enterprises' liquidity levels or funds management practices may need improvement. Holding company enterprises rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices at the parent company or subsidiary levels. However, these deficiencies are considered correctable in the normal course of business.

Earnings Rating 4. A rating of 4 indicates that the consolidated holding company enterprise's financial performance and earnings are clearly not sufficient to make full provision for losses and the necessary accretion of capital. Enterprises with earnings rated 4 may be characterized by erratic fluctuations in net income, poor earnings (and the likelihood of the development of a further downward trend), intermittent losses, chronically depressed earnings, or a substantial drop from previous performance. The liquidity levels or funds management practices of these holding company enterprises may be deficient. Holding company enterprises rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs at the parent company or subsidiary levels.

Earnings Rating 5. A rating of 5 indicates that the consolidated holding company enterprise has poor financial performance and one or more business lines or subsidiaries are experiencing losses. Such losses, if not reversed, represent a distinct threat to the enterprise's solvency through erosion of capital. In addition, these holding company enterprises' liquidity levels or funds management practices are critically deficient and may threaten continued viability. Holding company enterprises rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

SUMMARY

Financial stability, profitability, and liquidity are a few of the many critical factors to consider in the supervision of a thrift holding company enterprise. You must evaluate these factors in conjunction with one other to reach valid conclusions. You can measure financial strengths and weaknesses by conducting ratio analysis, reviewing financial statements, and monitoring market indicators.

Managers often operate the holding company and its subsidiaries, including the thrift, on a consolidated basis. While such integration provides advantages to both the thrift and the holding company, there are also potential pitfalls. Weaknesses in earnings or liquidity in one subsidiary can have a material affect on the viability of other subsidiaries or the entire holding company enterprise. You should assess earnings and liquidity from the perspective of the entire enterprise. You should also identify and assess the affect that the earnings and liquidity performance of key subsidiaries have on the enterprise or other subsidiaries.

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

EXAMINATION OBJECTIVE

To ensure that the scope of the examination is appropriate to adequately assess the risk exposure and complexity of the holding company enterprise.

PREEXAMINATION PROCEDURES

WKP. REF.

1. Determine if there is functional regulation of any entities in the holding company structure and identify the functional regulator (Securities and Exchange Commission, Commodity Futures Trading Commission, Financial Industry Regulatory Authority (FINRA), state insurance agencies, etc.). Also, determine if there is foreign regulation of financial entities in the holding company structure. If there are functional or foreign regulators involved, you must consider the italicized "Functionally or Foreign Regulated" procedures in this program. Also, note the functionally and foreign regulated entities and their primary regulators when you update the Regulatory Profile on Electronic Continuing Examination Folder (ECEF).

2. Forward the Preliminary Examination Response Kit (PERK) to the responsible holding company approximately one month before the estimated start date of the holding company examination. In most cases, the examination of the holding company will correspond to the examination of the "lead" savings association in the enterprise. (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 or Foreign Regulated-Review the PERK to determine if you can obtain any of the requested information through reports the company submits to functional or foreign 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 or a foreign regulated entity to the appropriate functional regulator contact (regional) or international affairs contact (headquarters). The functional or foreign regulatory contact should request information

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approximately six weeks before the examination of the lead association. This will allow the regulator sufficient time to submit its response to the regional office or OTS headquarters.

3. Review the subsidiary institution's most recent Regulatory Profile report on ECEF and the Holding Company Overview Report 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 before opening the new examination on the EDS/ROE system.

4. Perform preexamination/scoping analysis. Suggested scoping materials include:

- OTS Reports including (H-(b)11 Annual/Current Report, H-(b)10 Registration Statement).
- Securities and Exchange Commission reports (the company should include them with the H-(b)11 reports).
- Statements of financial condition and operations.
- 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 work papers.
- Supervisory correspondence.
- Recent applications, including conditions of approval.
- Examination reports from other regulatory agencies (domestic or foreign), including self-regulatory bodies such as FINRA.
- Other correspondence and data from functional or foreign regulators.
- Public sources: credit ratings by major rating agencies, newspaper or magazine articles, Reuters/AP Internet reports.
- Holding company and affiliate web sites.

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- Holding company board minutes.
- PERK.
- Subsidiary thrift's Regulatory Profile.

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

EXAMINATION PROCEDURES-OVERALL GUIDANCE

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

6. Verify compliance with supervisory directives and enforcement actions.

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

Functionally or Foreign Regulated-You should coordinate findings and recommended actions with functional or foreign regulators that oversee entities in the holding company enterprise. You should coordinate your communication through your regional contact (functional supervisors) or the international affairs staff in Washington, DC (foreign supervisors).

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PROCEDURES FOR FINALIZING THE EXAMINATION

7. Prepare the examination report and upload field final report comments to the ROE Center of the EDS/ROE system for manager review and approval.

8. Assign a composite rating to the holding company enterprise and assign component ratings for Category II and Category III holding company enterprises. Enter the ratings on the Ratings center of the EDS/ROE system.

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

   Functionally or Foreign Regulated - Coordinate with the other regulators on meetings that involve their entities. Invite other functional or foreign regulators of the holding company to participate when there are material findings.

10. Complete all Holding Company Examination Data System (EDS) entries (including reportable data, follow-up, and supplemental data) and upload work papers to the EDS/ROE system.

11. Update and make corrections as appropriate to OTS databases and reports, including the Regulatory Profile on ECEF and the holding company overview on the OTS Intranet.

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12. Enter the Actual Completion date into the Main EDS/ROE section. The regional or DC office will then finalize and transmit the examination report to the holding company.

Functionally or Foreign Regulated - You should follow the information sharing procedures outlined in the agreements OTS has executed with the primary regulators of functionally regulated and foreign regulated affiliates. As a rule, OTS will provide copies of the examination report and any other confidential information to the functionally regulated entity's primary regulator upon receipt of a written request that demonstrates a justifiable need for the information. The same rule applies to the primary regulator of foreign regulated entities. OTS will make the decision to share the report of examination or other confidential information on a case-by-case basis, only after the interested regulator provides sufficient rationale for requesting the information. You should consult with your region's functional regulation contact or with OTS's international affairs staff before agreeing to or actually releasing any confidential information.

RISK CLASSIFICATION CHECKLIST

In answering these questions, you should interpret the term "holding company" as the entire holding company enterprise, including all affiliates within a holding company family.

Determining Low Risk/Noncomplex Holding Companies With No Significant Activities Other Than the Thrift

	Yes	No
a) Is the holding company a noncomplex holding company with no significant activities other than the thrift? If Yes, go to Question b. If No, skip to Question e.		

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	Yes	No
b) Is the holding company only engaged in investing cash from dividends or proceeds from stock sales? If Yes, go to Question c. If No, skip to Question e.	______	______
c) Does the holding company have only minimal debt that it can easily service with its resources? If Yes, go to Question d. If No, skip to Question e.	______	______
d) In its cash management, does the holding company invest solely in U.S. 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	______	______
— Highly leveraged instruments	______	______

If you answered “Yes” to questions a, b, and c, and the answer to question d is liquid interest bearing instruments you will probably need to go no further. In most cases, the holding company you are reviewing is a low risk, noncomplex holding company with no significant activities other than the thrift. However, you should consider the nature of the investments held by the holding company as even highly rated mortgage securities may present liquidity or other risks.

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	Yes	No

You do not need to complete the remainder of this checklist. Refer to the Abbreviated Holding Company Examination Program, Section 720.

If the answer is highly leveraged interest bearing instruments, please continue. These 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 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 ____________ ____________

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, interest only strips, or residuals?

If Yes, review Capital and Earnings sections of Program 730 ____________ ____________

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 ____________ ____________

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	Yes	**No**
h) Is the holding company engaged in a cyclical industry or one that is distressed or clearly experiencing adverse trends? *If Yes, review Capital section of Program 730*	____	____
i) Does the holding company have a history of volatile operating earnings? *If Yes, review Earnings section of Program 730*	____	____
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, Standard and Poor's, Fitch Ratings, or A.M. Best? *If Yes, review Capital section of Program 730*	____	____

Financial Independence of the Thrift Subsidiary

	Yes	**No**
k) Is the thrift dependent on the holding company for access to the capital markets? *If Yes, review Capital section of Program 730*	____	____
l) Is the thrift unlikely to survive the financial collapse of the holding company or a major affiliate? *If Yes, review Risk Management section of Program 730*	____	____

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	Yes	No
Operational Independence of the Thrift Subsidiary		
m) Do the thrift's management and Board of Directors consistently act in a manner beholden to the holding company? *If Yes, review Risk Management section of Program 730*	___	___
n) Are the thrift's operational systems dependent upon the holding company or any of its affiliates? *If Yes, review Risk Management section of Program 730*	___	___
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 Risk Management section of Program 730*	___	___
p) Are the thrift's audit functions consolidated within the holding company, as opposed to having a separate, distinct audit department? *If Yes, review Risk Management section of Program 730*	___	___
q) Does the holding company or any of its affiliates perform most, if not all, key functions of the thrift, such as risk management, underwriting, investment advice, trading, and other banking or lending functions? *If Yes, review Risk Management section of Program 730*	___	___

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	Yes	No
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 Risk Management section of Program 730, and review Examination Handbook Section 330.*	____	____
— Are there significant or abusive intercompany or insider transactions such as loans, guarantees, asset purchases/sales, or service contracts? *If Yes, review Organizational Structure section of Program 730, and review Examination Handbook Section 380.*	____	____

Reputation Risk

	Yes	No
s) Is the thrift's public identity linked with the holding company, such as a similar name and marketing strategies? *If Yes, review Organizational Structure section of Program 730*	____	____
t) Is there significant cross-selling of proprietary products, like trusts, insurance policies, mutual funds, etc.? *If Yes, review Organizational Structure section of Program 730*	____	____
u) 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*	____	____

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	Yes	No
v) 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 Organizational Structure section of Program 730*		

Management Experience

	Yes	No
w) Is the holding company inexperienced in running a federally insured entity, as opposed to a history of managing banks and thrifts? *If Yes, review Risk Management section of Program 730*		
x) Is the thrift a de novo, as opposed to a thrift with existing management that has a proven track record? *If Yes, review Risk Management section of Program 730*		
y) Is the holding company relatively new, as opposed to a well established business with many years of successful operations? *If Yes, review Risk Management section of Program 730*		

Complexity of Operations

	Yes	No
z) Does the holding company conduct business or have operating entities in foreign markets or countries? *If Yes, review Organizational Structure section of Program 730*		

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	Yes	**No**
aa) Does the holding company engage in multiple forms of financial services (i.e., banking, insurance, securities brokerage, etc.)?		
If Yes, review Organizational Structure section of Program 730	______	______
bb) Does the holding company engage in commercial or other nonfinancial activities? (The Gramm-Leach-Bliley Act (GLBA) of 1999, restricted the creation of new thrift holding companies that engage in commercial or other nonfinancial activities. GLBA grandfathered most holding companies in existence at the time.)		
If Yes, review Organizational Structure section of Program 730	______	______
cc) Does the holding company engage in businesses, such as insurance or manufacturing, with significantly different auditing and accounting practices?		
If Yes, review Capital and Earnings sections of Program 730	______	______

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HOLDING COMPANY CLASSIFICATION

After completing the checklist, select the appropriate holding company categorization below. There is no rule that indicates how many "Yes" answers are necessary to classify a holding company between a Category I, a Category II, and a Category III. Use your judgments of the current and prospective risk exposures and complexity of operations to reach your conclusions. You should also consider consumer issues in your analysis, including what level of exposure there is to the deposit insurance fund, the level of consumer assets at risk, etc.

In general, if the thrift has 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 CORE procedures. 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.

For a financially troubled institution, you should consider a Category II classification even when the thrift has independent management, systems, and identity. Similarly, you should not classify any holding company with a 3, 4, or 5 composite rating as a Category I. Although OTS can successfully insulate 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 experiences a material financial downturn.

If you conclude that the firm is not a Category I, you must determine whether the level of complexity and risk warrants a Category II or a Category III classification. OTS reserves Category III classifications for complex, conglomerate holding company enterprises. To classify a holding company as a Category III, the company must conduct business internationally and engage in more than one type of financial service (banking, insurance, securities, etc.) or multiple financial and nonfinancial activities. You must consult with regional management and with senior management in Washington, DC before changing a firm's classification to or from a Category III. Senior management in Washington, DC will make the final determination based upon the input of regional management.

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(Please Check One)

The Holding Company is Noncomplex and not High Risk - Category I ________________

The Holding Company is Complex or Higher Risk – Category II ________________

The Holding Company is a Financial Conglomerate and High Risk - Category III

**Note: Senior management in Washington, DC must approve this classification.* ________________

Summarize the basis for your conclusion in your work papers.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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Program Guidance: You should only use this Abbreviated Holding Company Examination Program to examine low risk or noncomplex holding company enterprises. This program should not be used to examine high risk or complex holding companies (Category II) or Conglomerate (Category III) holding companies. When using this program, you should also consider the unique characteristics of the specialized holding company structures discussed in Sections 910-940. You should consult with the examiner-in-charge and complete the sections of the program that are 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 enterprise's financial resources relative to its risk profile.

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

Assess capital allocation and planning processes, including oversight and capital management.

Examination Procedures

Wkp. Ref.

1. Assess the holding company's ability to service its outstanding debt and the degree it relies on the thrift or other subsidiaries to upstream funds to service the debt. Determine whether double leveraging is occurring, and to what extent.

2. Assess the holding company's consolidated capital structure. Consider the quantity and composition of capital. Does the holding company enterprise have enough capital to meet its subsidiaries' regulatory requirements as well as protect the enterprise from risky activities or adverse events? Does capital provide a cushion to absorb unanticipated losses and to support the level and composition of borrowing?

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3. Does the holding company enterprise have sufficient capital to support its business plans and strategies, and/or the ability to enter capital markets to raise additional capital as necessary?

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

5. Evaluate the holding company's capital allocation and planning process in the context of its complexity. Determine whether capital management and oversight practices relate capital to risk, anticipate capital needs, and outline strategies to maintain sufficient capitalization as appropriate.

6. 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 enterprise, including the subsidiary thrift.

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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. (Refer to Section 400, pages 400.7-400.9 and Section 400, Appendix B.)

Identify and assess the inherent risks in the holding company enterprise's activities.

Examination Procedures

Wkp. Ref.

1. 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 affiliates.

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

3. Identify and evaluate the inherent risks in the holding company enterprise and determine whether the company engages in any impermissible activities.

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4. Determine the extent to which the holding company integrates the operations of the thrift or other affiliates within the holding company enterprise. Assess the risks posed by integrated systems, common risk management practices, central decision making, joint marketing and delivery systems, and linked market reputation. Evaluate whether the thrift can insulate itself from adverse events within the holding company structure and operate on a stand-alone basis.

5. Identify and analyze material asset, liability, and off-balance sheet concentrations.

6. Identify and analyze any tax-sharing agreements 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.

7. Identify and assess significant intra-group transactions. Assess the direct and indirect impact on the thrift and any other material subsidiaries of any significant transactions including asset purchases/sales, contracts for services, loans, or guarantees. If the transactions involve the thrift, ensure that it properly identifies them in its books and records. For thrift transactions, ensure they comply with the affiliate transaction regulations (12 CFR 563.41 and 563.42).

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R – Risk Management

Examination Objectives

Assess whether the board of directors and management identifies, understands, and controls the risks within the holding company enterprise.

Examination Procedures

Wkp. Ref.

1. Assess the influence of the holding company's board of directors and management. Consider the independence of the boards of directors of the thrift, holding company, and other affiliates. Do any relationships create the appearance of a conflict of interest or usurpation of corporate opportunity?

2. Assess the adequacy of the board and management's written policies, procedures, and limits. Evaluate changes and determine how they affect the risk-profile and financial condition of the company.

3. Determine if the holding company has adequate and accurate risk measurement and monitoring reports and systems as compared to similar holding companies of the same level of complexity.

4. Assess the adequacy of internal controls, books, records, and systems (relative to the holding company's complexity) to ensure that the holding company enterprise adequately manages risk.

5. Verify compliance with statutory and regulatory requirements.

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E – Earnings and Liquidity

Examination Objectives

Assess the holding company enterprise's overall financial performance, including earnings, profitability, liquidity and sources of funds.

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

Examination Procedures — Wkp. Ref.

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

2. Evaluate the holding company enterprise's overall financial performance, quantity and quality of earnings,

3. Evaluate the holding company enterprise's liquidity levels and funds management practices.

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

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Program Guidance: You should use this CORE Holding Company Program to examine higher risk or complex holding company enterprises. Also, consider the unique characteristics of the specialized holding company structures discussed in Section 900. You may also use this Program to supplement the Abbreviated Holding Company Examination Program (Section 720). You should consult with the examiner-in-charge and complete the sections of the program that are necessary to evaluate each CORE examination area and to support the overall examination conclusions.

C – Capital

Examination Objectives

Determine the holding company enterprise's financial resources relative to its risk profile.

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

Assess capital allocation and planning processes, including oversight and capital management.

Examination Procedures

Wkp. Ref.

1. Assess the holding company's ability to service its outstanding debt and the degree it relies on the thrift or other subsidiaries 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.

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- Determine to what degree the holding company has retained recourse (explicit or implicit) related to off-balance sheet funding activities such as asset securitizations.
- Consider whether the holding company is committed to investments with material cash needs or capital intensive business activities.

2. Assess the holding company's consolidated capital structure. Consider the quantity and composition of capital. Does the holding company enterprise have enough capital to meet its subsidiaries' regulatory requirements as well as protect the enterprise from risky activities or adverse events? Does capital provide a cushion to absorb unanticipated losses and to support the level and composition of borrowing?

3. Consider the overall risk profile you identify in the Organizational Structure review and assess all risk factors, including credit, market, operational, and legal risks in your analysis of capital adequacy.

- Determine if the holding company enterprise'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 adequacy change if you applied thrift capital conventions, bank holding company capital conventions, or the capital conventions of other functional or foreign regulators?
- 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 holding company relies on the thrift or another subsidiary, in whole or in part, to service such obligations?

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- 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.

4. In cases where capital is inadequate, discuss with management any plans to access the capital markets or otherwise augment capital.

5. Does the holding company enterprise have sufficient capital to support its business plans and strategies, and/or the ability to enter capital markets to raise additional capital as necessary?

6. 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.
   - Compare the dividend payout ratios, net income, and asset size of significant affiliates to assess relative contributions.

7. Evaluate the holding company's capital allocation and planning process in the context of its complexity. Determine whether capital management and oversight practices relate capital to risk, anticipate capital needs, and outline strategies to maintain sufficient capitalization.

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8. 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 enterprise, including the subsidiary thrift.

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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.

Identify and assess the inherent risks in the holding company enterprise's activities

Examination Procedures

Wkp. Ref.

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

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

   - Identify all tiers of the holding company. Ensure that the OTS holding company database accurately reflects the current structure.
   - Determine if the holding company has acquired, formed, divested, or transferred any subsidiaries or significant portion of its consolidated assets.

3. Determine whether any individual or entity – directly, indirectly, or by acting in concert – has acquired control (as defined in 12 CFR Part 574).

   - 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.)

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- Determine whether any changes in ownership (10 percent or more of voting stock) 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.

4. Consider exemptions contained in Section 10(a) of the Home Owners' Loan Act and 12 CFR Section 574.3.

5. Identify and evaluate the inherent risks in the holding company enterprise and determine whether the company engages in any impermissible activities.

   - Evaluate the risk that the activities of the holding company or other affiliates pose to the thrift or the entire enterprise.
   - 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.

6. Determine the extent to which the holding company integrates the operations of the thrift or other affiliates within the holding company enterprise. Assess the risks posed by integrated systems, common risk management practices, central decision making, joint marketing and delivery systems, and linked market reputation. Evaluate whether the thrift can insulate itself from adverse events within the holding company structure and operate on a stand-alone basis.

   - Assess the risk posed by integrated systems, common risk management practices, central decision making, joint marketing and delivery systems, linked market reputation, and common controls.

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- Assess the reputation risk posed by the linking the public identity of the holding company with affiliates, including the thrift. 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 or other affiliates.
- Evaluate whether the thrift can insulate itself from adverse events within the holding company structure and operate on a stand-alone basis. Ensure that it maintains a separate corporate identity.

7. Identify and analyze material asset, liability, and off-balance sheet concentrations. Include a summary of material concentrations in the report of examination.

8. Identify and analyze any tax-sharing agreements 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 governs the current practices of the consolidated group.
   - Determine that taxes the parent company collects from the thrift are not in excess of the amount that the thrift would pay if it filed a separate return.
   - Determine that the thrift's tax payments 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 thrift maintains deferred tax accounts on its own books and does not transfer them to the books of the holding company.

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- 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 there may be any material additional tax obligations 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 recoverability (from the holding company) that could result in chargebacks to the thrift.

9. Identify and assess significant intra-group transactions. Assess the direct and indirect impact on the thrift and any other material subsidiaries of any significant transactions including asset purchases/sales, contracts for services, loans, or guarantees. If the transactions involve the thrift, ensure that it properly identifies them in its books and records. For thrift transactions, ensure they comply with the affiliate transaction regulation (12 CFR 563.41).

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R – Risk Management

Examination Objectives

Assess whether the board of directors and management identifies, understands, and controls the risks within the holding company enterprise.

Examination Procedures

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1. Assess the influence of the holding company's board of directors and management. Consider the independence of the boards of directors of the thrift, holding company, and other affiliates. Do any relationships create the appearance of a conflict of interest or usurpation of corporate opportunity?

   - Determine the effect of accounting changes to the financial recordkeeping and reporting processes. Identify any material restatements and determine if they are the result of improper controls.
   - 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.

2. Assess the adequacy of the board and management's written policies, procedures, and limits. Evaluate changes and determine how they affect the risk-profile and financial condition of the company.

   - Verify that the policies and procedures are sufficient to manage the enterprise's level of risk and sufficiently address each of the material risk areas you identify in your review of Organizational Structure.
   - Ensure that the enterprise has sufficient policies and procedures for identifying, managing, and reporting risk concentrations.

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- Determine if the board's risk limits are reasonable and match the risk appetite of the enterprise. Also verify that the enterprise complies with the risk limits.

3. Determine if the holding company has adequate and accurate risk measurement and monitoring reports and systems.

4. Assess the adequacy of internal controls, books, records, and systems to ensure that the holding company enterprise adequately manages risk.

- Determine whether the financial statements, reports, and systems are complete, consistent, and accurate. Resolve any discrepancies.

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

- Identify who performs the external audit of the holding company, 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 the internal audit function is adequate and meets independence requirements.
- Determine the effect of accounting changes to the financial recordkeeping and reporting processes. Identify any material restatements and determine if they are the result of improper controls.
- 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.

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5. Verify compliance with statutory and regulatory requirements.

- Ensure that the holding company enterprise tracks and resolves outstanding examination and audit concerns. In particular, identify any corrective actions or formal enforcement actions and ensure their satisfactory resolution.
- Review the findings of functional and foreign regulators for material entities within the enterprise. Identify any patterns of violations that are material to the enterprise.

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E – EARNINGS AND LIQUIDITY

EXAMINATION OBJECTIVES

Assess the holding company enterprise's overall financial performance, including earnings, profitability, liquidity and sources of funds.

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

EXAMINATION PROCEDURES

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

2. Evaluate the holding company enterprise's overall financial performance, quantity and quality of earnings.

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3. Evaluate the holding company enterprise's liquidity levels and funds management practices.

4. Use external information to evaluate the 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.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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Introduction

OTS conducts routine off-site monitoring of holding company enterprises. The primary purpose of off-site monitoring is to identify developing material concerns or risks that may adversely affect the enterprise or its subsidiaries, including the thrift. The monitoring process will also help:

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

Monitoring will help identify and address potential problems, without being intrusive in the day-to-day operations of the holding company enterprise. When concerns arise, you should communicate with the holding company between examinations.

An ongoing dialogue with the management of the holding company is necessary. Ongoing communication enhances supervisory efforts and provides information about significant transactions or any changes in strategic direction. Such communication is particularly important for holding company enterprises involved in highly cyclical or rapidly evolving industries.

Periodic face-to-face meetings with management are appropriate for holding company enterprises categorized as high risk or complex (Category II). Periodic meetings will provide 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. Monitoring reviews should be risk-focused. *Because your monitoring review covers the entire holding company enterprise, you should review and incorporate key observations from thrift monitoring reports and other available information sources for key subsidiaries to ensure a thorough assessment and review of risk.*

Prioritizing Monitoring Reviews

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

- The holding company's relationship with its subsidiaries, including the thrift, and any potential burden that it places on those subsidiaries (for example dividends, tax or expense payments).
- Any significant deterioration in the financial condition or performance of the holding company enterprise.
- The inherent risk in the holding company enterprise.
- The holding company enterprise's 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 or other regulated subsidiaries.
- The asset size of both the holding company and the subsidiary thrift.
- Any significant events such as a proposed merger or acquisition.

For noncomplex holding company enterprises that have no debt or significant activities other than control of the thrift subsidiary, your monitoring activities should focus on the thrift condition/performance and any intercompany transactions or payments. For complex companies and noncomplex holding companies with outstanding debt, your review must address any significant deterioration in the financial condition or performance. The following ratios may assist you in prioritizing your monitoring reviews by giving an indication of the level of diversification and leverage.

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 percent indicates that the holding company has no assets other than the thrift, whereas a ratio of 200 percent would indicate that the thrift's assets represent one half of the holding company's consolidated assets. Higher ratios indicate 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 percent indicates that the holding company may have no source of income other than the thrift. A ratio greater than 100 percent 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 percent 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 an indication of the overall leverage within the enterprise. A negative or low total capital ratio often indicates that the holding company enterprise has limited capital resources. You should consider the composition of total capital when evaluating the adequacy of holding company capital. Holding company enterprises that have significant balances of intangible assets or other volatile assets relative to capital may not have the same capital stability as those 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 predictable cash flows that the holding company enterprise can rely on 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, generally accepted accounting principles (GAAP) characterizes mortgage-servicing assets as intangible assets; therefore, you should consider the impact of this component on entities with significant mortgage banking operations.

Do not confuse the tangible capital ratio with the regulatory capital requirements the Federal Reserve Board imposes on bank holding companies. OTS evaluates the adequacy of a holding company enterprise'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 helps evaluate 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 holding company enterprise; however, the ratio is not effective in identifying double leverage in holding company enterprises 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 noncomplex 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 a thrift pays to the holding company may diminish the thrift's ability to augment capital and support its risk profile. Thrifts that have higher dividend payout ratios may be less capable of supporting their 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 monitoring review should obtain an understanding of the following three areas:

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

- The holding company enterprise's financial condition and performance.

Several information sources 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 or market data;
- Shareholder reports;
- H (b)–11 Annual/Current Report;
- Annual audit reports;
- Holding company examination reports;
- Subsidiary examination report(s);
- Input from both the thrift and holding company examiners-in-charge;
- 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 information provided by other regulators involved in the holding company enterprise.

- 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. The subsidiary thrift files Schedule HC quarterly. For most holding company enterprises, OTS designates one holding company for which the thrift should provide this financial information. In some cases, where more than one distinct ownership path exists, there may be more than one designated filer. In addition, staff may designate additional filers if the information is necessary for supervisory purposes. As you analyze this information, you should test the accuracy of the financial data. Even when a thrift provides information on a consolidated basis for the designated filer, they may not include upper tier holding companies 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 attached to the Annual/Current H-(b)11 Report.

The collection of Schedule HC data provides an indication of the holding company's financial condition and trends. 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 diversified holding company enterprises, your monitoring efforts should focus on analyzing SEC filings, other comprehensive financials provided in the H-(b)11 filing, or 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. These discussions describe ratios that help analyze and spot trends regarding the holding company enterprise's capital adequacy, leveraging, earnings, liquidity, cash flow, and reliance on subsidiary dividends. They can also help evaluate financial aspects of the holding company enterprise's relationship with the thrift.

Please note: The results of the ratio calculations outlined in Sections 300 and 600 should not lead you automatically to assume there is a problem. Results of the calculations that indicate a potential problem should result in additional scrutiny of the activities of the holding company enterprise to determine whether risks exist.

Periodic Reports. OTS requires holding companies to file defined periodic reports. The instructions for form H-b(11) Annual/Current Report outline OTS's requirements for periodic reports. Holding companies must file this report within 90 days of their fiscal year end. In addition, they must file quarterly updates 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 there were no changes.

The H-(b)11 instructions require holding companies to provide audited financial statements and copies of SEC filings as well as identify other materially important events

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

- www.fitchratings.com (FITCH IBCA, DUFF & PHELPS)
- www.ambest.com (AM BEST)(for holding company enterprises with insurance as their primary business)
- www.moodys.com (MOODY'S INVESTORS SERVICE)
- www.standardpoor.com (STANDARD & POOR'S). The "News and Commentary" section includes information on industries including Financial Institutions and Insurance. In addition, the "Credit Ratings Actions" section includes ratings news.

In enterprises that have another primary regulator, you should leverage 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 include those applications that substantially increase the risk profile of the thrift or holding company; involve novel or complex transactions; or propose a significant shift in business strategy. OTS considers all complex holding company and de novo applications as 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 that were important considerations in the approval of the application, but were not memorialized in a condition. These include issues requiring follow-up.
- Business plan projections. This includes performing a quarterly review of the thrift or holding company's adherence to the financial projections the region accepted. This review should assess both the volume and type of business activities 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, you must identify these areas of noncompliance and route them through your supervisor to the attention of the Regional Director. Supervisory corrective action will be implemented based upon regional evaluation of the severity of the noncompliance.

Generally, the monitoring requirements for major applications sunset 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 monitoring findings for any areas where you identify significant financial deterioration or supervisory concerns. You should present your review comments in a simple, 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 enterprise, and does not reveal any new information that would cause 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(l) 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(l) 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.

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[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 institution. 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.

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-

[5] Information about Separate Accounts is included in Appendix A.

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 receivership, 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 intragroup 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

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, intragroup 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.

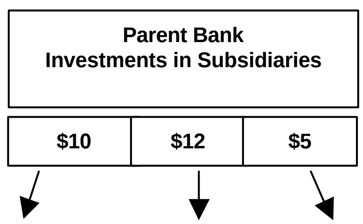
[3] In this example we have developed a notional capital proxy for the unregulated finance subsidiary. If it is not possible to develop a proxy for an unregulated entity, you will need to deduct that entity from the conglomerate's group wide totals. In this example you would need to deduct the unregulated 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):

Parent Bank Investments in Subsidiaries		
$10	**$12**	**$5**

	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.