

INTRODUCTION

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

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

EXAMINATION AUTHORITY

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

There are two exceptions to this broad grant of holding company examination authority. First, if a holding company is a bank holding company that owns both a bank and a thrift, then the Federal Reserve Board regulates the holding company. Secondly, if the holding company has a functionally regulated subsidiary, then we will coordinate our information requests and examina-

tions with the entity's primary regulator. The functional regulation provisions are discussed in greater detail later in this Section. These provisions were enacted to avoid regulatory duplication. In so doing, they specify certain procedural requirements in requesting information and conducting an examination of certain types of entities. Because of this, our examination process must follow certain prescribed steps.

REGULATORY COORDINATION AND COMMUNICATION

Regional Responsibility

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

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

Functional Regulation

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

What Entities Are Functionally Regulated?

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

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

If you identify a subsidiary of the holding company (or the thrift), that is a functionally regulated entity, then you must follow the procedures out-

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

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

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

Step 1 – Using Available Information

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

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

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

Step 2 – Requesting Information Through the Primary Regulator

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

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

Step 3 – Requesting Information From the Functionally Regulated Entity

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

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

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

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

Step 4 – When to Pursue an Examination

If you cannot address your concerns with the information made available in the above detailed

steps, and you have relied on the examination reports of the primary regulator to the fullest extent possible, then you can examine the entity.¹ After all, if you have concerns after reviewing all the information acquired up to this point, it should be relatively easy to meet one or more of the following criteria required by statute to examine a functionally regulated affiliate:

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

Step 5 – Examination

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

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

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

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

OR

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

Whenever possible, you should:

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

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

Foreign-Based Holding Companies

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

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

PREEXAMINATION ANALYSIS

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

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

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

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

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

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

Holding Company Risk Classifications

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

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

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

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

The following chart summarizes the appropriate program to use:

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

ON-SITE EXAMINATION

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

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

However, holding company examinations may require the exercise of additional procedures that would not be applicable to a thrift examination. For example, a complex holding company structure may have one or more tiers of companies

between the thrift and the top tier holding company. Further, there may be large noninsured subsidiaries of the holding company that are significant businesses in their own right.

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

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

POSTEXAMINATION PROCEDURES

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

The Closing Meeting

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

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

Meetings with the Board of Directors

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

The Report of Examination

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

Rating the Holding Company Enterprise

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

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

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

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

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

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

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

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

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

impaired. Enterprises deserving of this rating will predominantly have components that are rated 3, although even one component with a 3 rating may suffice to justify an overall U rating if the problems are severe enough.

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

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

Integration with Thrift Report of Examination

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

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

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

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

SUMMARY

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

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

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

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

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