

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

LINKS

 [Appendix A](#)

 [Appendix B](#)

 [Appendix C](#)

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.

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 activities² 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.

<i>Type of HC +</i>	<i>HC in Existence or Filed Application by 5/4/1999 +</i>	<i>QTL Status =</i>	<i>Activity Limitations</i>
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 Act⁷ and the OTS's management interlocks regulation⁸, 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 enti-

ties, 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. Cur-

rency 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.