

Financial Institutions Regulatory *UPDATE*

SEPTEMBER 2003

REGULATION O REPORTING AND RECORDKEEPING REQUIREMENTS—IS RELIEF ON THE WAY?

Lending to insiders is a regulatory “danger zone” for the banker. Banks are subject to a host of rules specifically governing extensions of credit to officers, directors, principal shareholders and certain other parties and significant recordkeeping and reporting obligations relating to such transactions. The most well-known and universally applicable set of rules governing loans to insiders are set forth in Sections 22(g) and 22(h) of the Federal Reserve Act (codified at 12 U.S.C. §§ 375a and 375b respectively) and implementing Regulation O of the Board of Governors of the Federal Reserve System (codified at 12 C.F.R. § 215) (“Regulation O”).¹ Regulation O applies to both state and federally chartered commercial banks, savings associations and savings banks, and not just member banks of the Federal Reserve System. (This Update will use the term “bank” to refer to institutions subject to these requirements.)

The Office of the Comptroller of the Currency (“OCC”) (at 12 C.F.R. § 31.2), the Federal Deposit Insurance Corporation (“FDIC”) (at 12 C.F.R. § 337.3), and the Office of Thrift Supervision (“OTS”) (at 12 C.F.R. § 563.43) also have each promulgated regulations subjecting the institutions they regulate generally (all referred to as “banks”) to Regulation O, which applies to loans and extensions of credit by a bank to its executive officers, directors, principal shareholders and their related interests (collectively “insiders”) and insiders of its holding company or holding company subsidiaries.

The recordkeeping and reporting are among the least well-known and more complicated requirements of Regulation O. It is very easy to overlook one or more of these obligations as the attachment to this Update

shows. Some reports are made to regulators, others to the institution or its board of directors. Some are made annually, others quarterly and still others within a stated period of time after the occurrence of an event. In some cases, the institution has an obligation to file a report with regulators. In others, the executive officer, director or principal shareholder is obligated to file a report with the full board. But help may be on the way in the form of H.R. 1375, the Financial Services Regulatory Relief Act of 2003 (“Regulatory Relief Bill”). The Regulatory Relief Bill, if enacted, would eliminate some Regulation O recordkeeping and reporting requirements. This Update reviews the current Regulation O recordkeeping and reporting requirements and explains how the Regulatory Relief Bill, if enacted into law, would eliminate some of these requirements.

However, whether and when such relief ultimately will be enacted are both uncertain. Therefore, institutions must continue to comply with all of these provisions until repeal is effective and, if certain of these requirements are repealed by this legislation, institutions must continue to comply with the remaining reporting and recordkeeping requirements.

RECORDKEEPING REQUIREMENTS

A bank is obligated to maintain records that demonstrate its compliance with Regulation O.

12 C.F.R. § 215.8(a).

The bank itself must compile an annual survey that identifies all persons or entities qualifying as insiders. 12 C.F.R. § 215.8(b)(1). This is not as simple as it might initially appear for several reasons. First, a bank

¹ Insider reporting and disclosure requirements relating to extensions of credit from correspondent banks and included in Regulation O implement Section 106(b)(2)(G) of the Bank Holding Company Act Amendments of 1970, 12 U.S.C. § 1972(2)(g).

frequently forgets to take an annual board vote identifying its “executive officers” who are authorized to participate in “major policymaking functions.” By not doing this, the bank increases the likelihood that every vice president will be treated as an “executive officer” subject to Regulation O reporting. This is unnecessary and can be burdensome. Second, banks often fail to identify new “related interests” of existing insiders created since the last annual survey. The obligation to conduct a survey to identify all insiders to the bank is annual. The bank should keep records showing that it actually conducted an annual survey.

A bank is also required to maintain records of any extensions of credit to insiders, including the amount and terms of each extension of credit. 12 C.F.R. § 215.8(b)(2). The standard borrower loan file with the record of the extension of credit should be sufficient for these purposes. Regulation O does not require a bank to keep a special log of, or segregate loan files on, extensions of credit made to insiders. Banks often keep such logs to help track extensions of credit to insiders that may have been on their books at some point during the examination period and subsequently repaid or sold.

In addition to the “survey” method, Regulation O gives a bank two other recordkeeping options for extensions of credit by the bank to insiders of the holding company or its affiliates—the “borrower inquiry” and the “alternative” methods. Under the “borrower inquiry” method, the bank can ask the borrower to identify itself as an insider of the holding company or affiliate and maintain records identifying the amount and terms of any extension of credit to a borrower identifying itself as an insider. 12 C.F.R. § 215.8(c)(2). In other words, the bank can shift responsibility for identifying insiders of its holding company or the holding company’s affiliates by asking its borrower to identify itself as such an insider. Under the “alternative” method, the bank can use any other method of recordkeeping to track extensions of credit to insiders of a holding company and holding company affiliates that the bank’s primary federal banking regulator determines to be “at least as effective” as the survey or borrower inquiry methods. 12 C.F.R. § 215.8(c)(3).

REPORTING REQUIREMENTS

Regulation O has seven distinct reporting or disclosure requirements for extensions of credit to insiders.

1. Report of Extensions of Credit by Bank to Executive Officer

Regulation O allows a bank to extend credit to its executive officers in the following limited situations: to finance the education of their children; to finance or refinance the acquisition, construction or improvement of a personal residence secured by a first mortgage lien; a borrowing fully secured by U.S. Government obligations or deposit account; or for any other purposes which do not exceed the greater of 2.5% of the bank’s unimpaired capital and surplus or \$25,000, but in no event more than \$100,000. 12 C.F.R. § 215.5(c). Any extension of credit by a bank to any of its executive officers must be promptly reported by the executive officer to the board of directors. 12 C.F.R. § 215.5(d)(1). The report should be in writing.

2. Report by Executive Officer of Extensions of Credit from Other Banks

An executive officer of a bank who becomes indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit in 12 C.F.R. § 215.5(c) described immediately above must, within ten days of the date the indebtedness reaches such a level, make a written report to the board of directors of the officer’s bank. 12 C.F.R. § 215.9. Typically under this requirement, executive officers are required to report aggregate extensions of so-called “other purpose loans” in excess of \$100,000. The report must state the lender’s name, the date and amount of each extension of credit, any security for it, and the purposes for which the proceeds have been or are to be used. 12 C.F.R. § 215.9.

3. Filings for New Extensions of Credit to Executive Officers with Call Report

A bank must include with (but not as part of) each report of condition (quarterly call report) filed pursuant to 12 U.S.C. § 1817(a)(3) a report of all extensions of

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credit made by the bank to its executive officers since the date of the previous report of condition. 12 C.F.R. § 215.10.

4. Public Disclosure of Extensions of Credit by a Bank to its Executive Officers and Principal Shareholders

Upon receipt of a written request from the public, a bank must make available the names of each of its executive officers and each of its principal shareholders (*i.e.*, shareholders who own or control more than 10% of any class of voting stock) to whom, or to whose related interests, the bank had outstanding as of the end of the latest previous quarter of the year, an extension of credit that, when aggregated with all other outstanding extensions of credit at such time from the bank to such person and to all related interests of such person, equaled or exceeded 5% of the bank's capital and unimpaired surplus or \$500,000, whichever amount is less. No disclosure is required if the aggregate amount of all extensions of credit outstanding at such time from the bank to the executive officer or principal shareholder of the bank and to all related interests of such a person does not exceed \$25,000. A bank is not required to disclose the specific amounts of individual extensions of credit. 12 U.S.C. § 1817(k); 12 C.F.R. § 215.11(b); 12 C.F.R. § 349.4.

A bank must maintain records of all requests for the information described in the preceding paragraph, and the disposition of such requests. These records may be disposed of two years from the date of the request. 12 C.F.R. § 215.11(c); 12 C.F.R. § 349.4(c).

12 C.F.R. § 215.11 does not apply to state-chartered, nonmember banks. 12 C.F.R. § 337.3(a). However, FDIC has issued its own regulations containing the same requirements. 12 C.F.R. § 349.4.

5. Report of Extensions of Credit to Executive Officers or Directors Secured by Bank Stock

Each executive officer or director of a bank whose shares are not publicly traded must report annually to the board of directors the outstanding amount of any

credit that was extended to the executive officer or director and is secured by shares of the bank. 12 C.F.R. § 215.12.

6. Report by Executive Officers and Principal Shareholders of Outstanding Extension of Credit from Correspondent Banks

If during any calendar year an executive officer or principal shareholder of a bank or a related interest of such a person has outstanding an extension of credit from a correspondent bank, the executive officer or principal shareholder must, on or before January 31 of the following year, make a written report to the board of directors of the bank. 12 C.F.R. § 215.22(a); 12 C.F.R. § 349.3(a). The report (FFIEC Form 004) must contain: (1) the maximum amount of indebtedness of the executive officer or principal shareholder and of each of that person's related interests to each of the bank's correspondent banks during the calendar year; (2) the amount of indebtedness of the executive officer or principal shareholder and of each of that person's related interests outstanding to each of the bank's correspondent banks as of ten business days before the report is filed²; and (3) a description of the terms and conditions (including the range of interest rates, the original amount and date, maturity date, payment terms, security, if any, and any other unusual terms or conditions) of each extension of credit included in the indebtedness report. 12 C.F.R. § 215.22(b); 12 C.F.R. § 349.3(b).

The FFIEC Form 004 report must be retained for at least three years. It need not be made available to the public nor filed with the bank's primary federal regulator (unless specifically requested). 12 C.F.R. § 215.22(d); 12 C.F.R. § 349.3(c).

A bank must advise each of its executive officers and principal shareholders (to the extent known by the bank) of the FFIEC Form 004 report requirement, and must make a list of the names and addresses of its correspondent banks available to each of these persons so they have the information necessary to allow them to complete the form. 12 C.F.R. § 215.22(e); 12 C.F.R.

² If the amount of indebtedness outstanding to a correspondent bank ten days before the filing of the report is not available or cannot be readily ascertained, the amount may be estimated in the report, so long as the report is supplemented within the next 30 days with the actual amount of indebtedness. 12 C.F.R. § 215.22(b)(2), fn. 6; 12 C.F.R. § 349.3(b)(2), fn. 3.

§ 349.3(d). 12 C.F.R. §§ 215.20 – 215.22 do not apply to state-chartered, nonmember banks. 12 C.F.R. § 337.3(a). FDIC has, however, issued its own regulations containing the same reporting requirements. 12 C.F.R. § 349.3.

7. Public Disclosure of Extensions of Credit by Correspondent Banks to Executive Officers and Principal Shareholders

Upon receipt of a request from the public, a bank must make available the names of each of its executive officers and each of its principal shareholders to whom, or to whose related interests, any correspondent bank of the bank had outstanding, at any time during the previous calendar year, an extension of credit that, when aggregated with all other outstanding extensions of credit at such time from all correspondent banks to such person and to all related interests of such person, equaled or exceeded 5% of the bank's capital and unimpaired surplus or \$500,000, whichever is less. No disclosure is required if the aggregate amount of all extensions of credit outstanding from all correspondent banks to the executive officer or principal shareholder of the bank and to all related interests of such a person does not exceed \$25,000 at any time during the previous calendar year. 12 C.F.R. § 215.23; 12 C.F.R. § 349.4. A bank is not required to disclose the specific amounts of individual extensions of credit. A bank must maintain records of all public requests for the information for two years. 12 C.F.R. § 215.23(b); 12 C.F.R. § 349.4(c).

IMPACT OF REGULATORY RELIEF BILL ON INSIDER LENDING REPORTING REQUIREMENTS

The Regulatory Relief Bill, which was approved by the House Committee on Financial Services on May 29, 2003 and by the House Committee of the Judiciary on July 9, 2003, contains numerous proposed changes, primarily of a technical nature, to federal banking laws. Section 403 of the Regulatory Relief Bill would repeal the following four of the insider lending reporting requirements described above:

1. Reporting of Certain Executive Officer Loans from Other Banks

As described above, Section 22(g)(6) of the Federal Reserve Act (12 U.S.C. § 375a(6)) and its implementing regulation in Regulation O (12 C.F.R. § 215.9) obligate an executive officer of a bank to file a report with the board of directors whenever he or she obtains extensions of credit from other banks that in the aggregate exceed the higher of 2.5% of unimpaired capital and surplus or \$25,000, but in no event more than \$100,000 (excluding a first mortgage loan secured by a personal residence, educational loans for the executive officer's children and loans fully secured by U.S. Government obligations or bank deposits ("Excluded Loans")). FRB has long looked with disfavor on Section 22(g)(6) and 12 C.F.R. § 215.9 for a number of reasons. First, there is little benefit to the effective monitoring of insider lending from either a bank or its regulators knowing that an executive officer has more than \$100,000 in loans from another bank that do not qualify as Excluded Loans. The bank making the loan need not have a correspondent relationship with the executive officer's bank for the reporting obligation to apply. Furthermore, the executive officer can avoid the reporting obligation simply by obtaining extensions of credit from non-bank lenders. Second, the reporting obligation is difficult to enforce and can be unnecessarily intrusive of an executive officer's privacy. Executive officers frequently overlook the requirement to report the details of a third-party loan from a bank with no correspondent or business relationship to their employer bank. They can have legitimate concerns with the fact that the law currently requires an executive officer of a bank to report in writing "the purposes for which the proceeds have been or are to be used" to the board of directors. Employers are generally not entitled to know the details of their employees' personal finances absent some compelling reason. That reason may exist where the bank lending to an executive officer of another bank has a correspondent or other important business relationship with an executive officer's bank. It is not likely to be present where there is no such relationship. The Regulatory Relief Bill would eliminate this reporting requirement.

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2. Reporting of New Extensions of Credit on Quarterly Call Reports

Section 22(g)(9) of the Federal Reserve Act (12 U.S.C. § 375a(9)) and its implementing regulation in Regulation O (12 C.F.R. § 215.10) obligate a bank to report every new extension of credit by the bank to an executive officer on the first call report to be filed after the extension of credit. There appears to be little justification for mandatory reporting of every new extension of credit by a bank to an executive officer. Many loans to executive officers are limited in purpose and/or amount and are normally given a high degree of scrutiny in both the corporate approval and subsequent regulatory examination process. There appears to be little justification for mandatory reporting in a quarterly call report, for example, of a \$15,000 education loan to an executive officer to pay his or her daughter's college tuition. But that is what the law currently requires. The Regulatory Relief Bill would eliminate this reporting requirement.

3. Reporting of Extensions of Credit by Executive Officers and Principal Shareholders from Correspondent Banks

Section 106(b)(2)(G)(i) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. § 1972(2)(g)(i)) and its implementing regulations in Regulation O (12 C.F.R. § 215.22) and FDIC Regulations (12 C.F.R. § 349.3) obligate executive officers and principal shareholders of a bank to report annually to the board of directors any outstanding indebtedness by them or their related interests (generally, companies controlled by them) to correspondent banks. This report is made on FFIEC Form 004 by January 31 for the preceding calendar year. Section 403(b) of the Regulatory Relief Bill would eliminate this reporting requirement.

4. Public Disclosure of Extensions of Credit by Correspondent Banks to Executive Officers and Principal Shareholders

Section 106(b)(2)(G)(ii) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. § 1972(2)(g)(ii)) and its implementing regulation in Regulation O (12

C.F.R. § 215.23) and FDIC Regulations (12 C.F.R. § 349.4) obligate banks, in response to requests from the public, to disclose the names of any executive officer, principal shareholder or related interests thereto with extensions of credit in excess of the lesser of 5% of the bank's unimpaired capital and surplus or \$500,000 from the bank's correspondent banks during the previous calendar year. Section 403(b) of the Regulatory Relief Bill would eliminate these public disclosure obligations.

OUTLOOK FOR REPEAL OF REPORTING REQUIREMENTS

The Regulatory Relief Bill, which would repeal the foregoing four insider lending reporting requirements, is now awaiting consideration by the full House of Representatives. A vote by the House has been delayed because of, among other things, concerns raised with respect to an unrelated provision that would facilitate the ability of industrial loan companies ("ILCs"), as well as banks, to branch *de novo* across state lines. This provision has raised concerns that commercial companies, such as Wal-Mart, which can acquire ILCs, could utilize ILCs to engage in nationwide retail banking activities.

The Senate Committee on Banking, Housing, and Urban Affairs ("Senate Banking Committee") has not yet considered any bill this year similar to H.R. 1375. And while Senator Shelby, Chairman of the Senate Banking Committee, has requested views of interested parties on a regulatory relief bill, no draft text has yet to be introduced in the Senate.

Therefore, there is significant uncertainty with respect to the enactment of H.R. 1375 this year. However, if this legislation is not enacted this year, since 2003 is the first year of the two-year Congressional session, there would still be an opportunity in 2004 to enact H.R. 1375 and the repeal of the insider lending reporting requirements discussed above.

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REGULATION O REPORTING AND RECORDKEEPING REQUIREMENTS

	Requirement	Frequency	Responsibility Of	Reported To	Comment
1.	Survey to identify all executive officers, directors, principal shareholders and related interests. 12 CFR 215.8(b)(1).	Annual	Bank	Board of Directors	Bank should take annual vote to identify "executive officers" with policy making authority, thereby excluding all other officers from the Regulation O executive officer requirements.
2.	Request each executive officer, director, principal shareholder to identify related interests. 12 CFR 215.8(b)(1).	Annual	Executive officers, directors and principal shareholders	Bank	This is related to Item 1. Compliance officer should be careful to identify new "related interests" of existing insiders annually.
3.	Maintain records showing each extension of credit, its amount and terms to each executive officer, director, principal shareholder and their related interests. 12 CFR 215.8(b)(2).	Continuous	Bank	Board of Directors	A standard report format should be developed to be completed by the compliance officer or designee for each extension of credit to an insider.
4.	Survey to identify all executive officers, directors, principal shareholders and related interests of holding company affiliates. 12 CFR 215.8(c)(1).	Annual	Bank	Board of Directors	Bank can use an annual survey, borrower inquiry method or other recordkeeping method its primary federal regulator deems effective.
5.	Report any extension of credit by bank to executive officer. 12 CFR 215.5(d)(1).	Promptly after extension of credit made	Executive officer receiving the extension of credit	Board of Directors	Extension of credit must be promptly reported to the board of directors (and presumably in writing).
6.	Report any extension of credit by another bank to an executive officer. 12 CFR 215.9.	Within 10 days of becoming indebted to other banks	Executive officer receiving the extension of credit	Board of Directors	Report must be (i) in writing, and (ii) state the lender's name, the date and amount of each extension of credit, any collateral and the purpose of the loan. Report must be made if and when the aggregate amount of the debt owed by the executive officer to other banks (excluding a first mortgage on a residence, children's educational loans, loans fully secured by U.S. Government obligations or bank deposits) exceeds the greater of 2.5% of unimpaired capital and surplus or \$25,000, but in no event more than \$100,000.

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	Requirement	Frequency	Responsibility Of	Reported To	Comment
7.	Report new extensions of credit to executive officers with call reports. 12 CFR 215.10.	Quarterly	Bank	Primary federal regulator	A report of all new extensions of credit to executive officers since the previous call report must be filed with the next call report.
8.	Report extensions of credit secured by stock of executive officers or directors in non-publicly traded banks. 12 CFR 215.12.	Annual	Executive officer or director of non-publicly traded bank pledging stock	Board of Directors	Only applies to non-publicly traded banks. Affected officer or director must report the outstanding amount of any credit extended and that it is secured by bank stock.
9.	Report by executive officer or principal shareholder of outstanding indebtedness by them or their related interests to correspondent banks. 12 CFR 215.22; 12 CFR 349.3.	Annual; by January 31 for preceding calendar year	Executive officer or principal shareholder	Board of Directors (and primary federal regulator if so required)	Bank should notify executive officers and principal shareholders of reporting requirement, make available to them a list of its correspondent banks and keep the reports for three years. Bank should compile all information on FFIEC Form 004. Consumer loans of less than \$5,000 on market terms need not be reported.
10.	Public disclosure of executive officers and principal shareholders who (together with their related interests) had extensions of credit from the bank as of the close of the previous quarter exceeding the lesser of \$500,000 or 5% of unimpaired capital and surplus. 12 CFR 215.11(b); 12 CFR 349.4.	Upon receipt of written request	Bank	Public	The list need only provide the aggregate amount of credit to an executive officer or principal shareholder (and related interests). Public disclosure does not apply to directors. Bank must keep records of all requests for information and its disposition of same for two years.
11.	Public disclosure of a list of executive officers and principal shareholders who (together with their related interests) had extensions of credit from the bank's correspondent banks at any time during the previous calendar year that exceeded the lesser of 5% of the bank's unimpaired capital and surplus or \$500,000. 12 CFR 215.23; 12 CFR 349.4.	Upon receipt of written request	Bank	Public	The list need only provide the aggregate amount of credit to an executive officer or principal shareholder (and related interests). Public disclosure does not apply to directors. Bank must keep records of all requests for information and its disposition of same for two years.

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