

Related Organizations Program

EXAMINATION OBJECTIVES

The overall objective of the related organization review is to determine the degree of risk that the related organization(s) presents to the parent thrift and to implement corrective actions as necessary.

Administration

To establish a risk-focused examination scope based on an understanding of the related organization and its effect on the parent thrift.

Management Quality

To assess the related organization's management expertise and performance through an evaluation of management policies, procedures and strategic planning.

Asset Quality

To ascertain the extent to which the related organization's practices serve to recognize and control risk inherent in the asset portfolio and properly value the parent thrift's investment.

Earnings

To identify factors relevant to the related organization's financial condition that may materially affect the parent thrift's operating results and financial condition.

Compliance

To determine whether the related organization is operated in accordance with laws, regulations, and policy directives.

EXAMINATION PROCEDURES

ADMINISTRATION

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1. Perform a pre-examination analysis:
 - Gather and review the PERK and other background information (i.e., audit reports, correspondence with regulators, OTS approval orders.)

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- Obtain an understanding of the related organization, its relationship with the parent thrift and issues pertinent to the review (i.e., review organizational charts and the effect of recent changes in the structure on the organization, assess the significance of the subsidiary's operations by comparing its activity levels and size to those of the parent thrift, determine the extent to which the parent thrift depends on the related organization's income).
- Determine if the related organization is included in the parent thrift's regulatory capital.
- Identify the ownership and controlling interests of the related organization and any lower tier subsidiaries.

2. Review the previous report of examination and all related organization exceptions noted and determine if management has taken appropriate corrective action.

3. Review the Matters Requiring Board Attention and Corrective Actions from the three or four previous ROEs to ensure that the board and management have taken appropriate corrective action where necessary and persistent problems have not recurred.

4. Establish an initial examination scope.

5. Perform examination procedures relating to management quality, asset quality, earnings and compliance. (Generally, all relevant Level I procedures should be performed.)

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6. Modify the examination scope, as necessary, and perform any additional procedures under Level II or other applicable Handbook sections (i.e., Handbook Section 710, Networking Arrangements, Section 720, Insurance, and Section 740, Real Estate Development).

7. Conduct meetings with management to review examination findings.

8. Formulate a response to unsafe and unsound practices (refer to Examination Handbook Section 080, Enforcement Actions, and Regulatory Bulletin 18) and make criminal referrals, if appropriate (see Handbook Section 360, Fraud/Insider Abuse).

9. Prepare report comments and assign a subfactor rating based on the combined risk that the related organization(s) poses to the parent association.

10. Recommend the timing and scope of the next examination.

MANAGEMENT QUALITY

LEVEL I

11. Identify key decision-making personnel and obtain an understanding of their responsibilities.

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12. Verify that executive compensation arrangements have been approved by the organization's board of directors and do not present significant concerns that could lead to material financial loss to the parent thrift.
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13. Confirm that policies (i.e., conflicts of interest), and procedures (i.e., internal controls detailed in Handbook Section 340) have been approved by the organization's board of directors and established for major areas of the entity's operations.
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14. Obtain and analyze periodic reports submitted to executive management of the organization and parent thrift to determine their usefulness in monitoring the operations and condition of the related organization.
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15. Verify that the related organization's board of directors has access to information necessary to make informed decisions.

LEVEL II

16. Assess the expertise and performance of the related organization's directors. (Does the directorate operate independently of management and the parent thrift? Does the directorate provide adequate oversight? Do third parties report directly to the board of directors?)
-
17. Evaluate management's expertise (i.e., technical proficiency, knowledge of the legal and regulatory environment, leadership and administrative abilities) and performance in relation to internal goals and the parent thrift's objectives.
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18. Assess management's practices (i.e., communication, adherence to plans and policies, internal controls, periodic review of policies, ongoing supervision, and monitoring of operations).

19. Determine the overall effectiveness of management as evidenced by the related organization's performance (i.e., determine if strategic planning is adequate, evaluate the feasibility of long range plans, and assess management's planning for staffing needs).

ASSET QUALITY

LEVEL I

20. Determine whether asset quality can have a material effect on the parent thrift's regulatory capital.

21. When material, identify risks relative to asset types. (Is the subsidiary engaging in new activities? Does the portfolio consist primarily of one type of asset? Is management expertise adequate to manage the portfolio?)

22. When material, evaluate the adequacy of the organization's asset underwriting policies and procedures.

23. When material, determine the adequacy of the organization's internal asset review, classification, and valuation systems.

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LEVEL II

24. Assess the risk exposure of the organization's asset portfolio. (See Handbook Chapter 200, Asset Quality.)

25. Ascertain compliance with the related organization's underwriting policies and procedures.

26. Determine the effectiveness of internal asset review and classification systems.

27. Determine whether asset valuations should be adjusted. (Was the correct valuation method used? Is the valuation allowance adequate?)

28. Perform the following for finance subsidiaries:

- Determine whether the security has been unnecessarily over- or under-collateralized.
- Determine whether the amount of default and interest-rate risks of the new investments of the parent are greater than the same risks for the assets collateralizing the securities.
- Determine whether the prepayment assumptions on underlying collateral are realistic.

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EARNINGS ANALYSIS

LEVEL I

29. Review prior examination reports (and work papers), audit reports, additional regional office monitoring reports, and any analysis performed by regulators to ascertain strengths and weaknesses in the related organization's operations.
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30. Evaluate procedures for completing and submitting timely reports to regulatory authorities.
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31. Determine whether material changes in accounting methods have been implemented since the most recent external and/or internal audit.
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32. Review debt agreements entered into since the prior examination for unusual requirements, covenants and parent association guarantees. (The agreement should state that the parent thrift is not liable for the debt, unless the parent has guaranteed the debt.)
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33. Analyze the stability of operating results and explain trends, and material variances (from prior results or business plan projections) that materially effect the related organization's financial position (i.e., adequacy of capital, liquidity needs).
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34. Determine the effect on regulatory capital due to asset valuation or other accounting adjustments.
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LEVEL II

35. Verify the accuracy of reports submitted to regulatory authorities. (If necessary, reconcile and determine the materiality of intercompany accounts.)
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36. Evaluate deviations from acceptable accounting standards as identified in the external and/or internal audit reports.
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37. Analyze the organization's ability to service and manage its debt and the risk related to debt guarantees made by the parent thrift.
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38. Assess the effect of contingencies and commitments on the subsidiary and parent association. (Consider the subsidiary's asset size, liquidity position and capital level. Do policies and procedures exist for identifying and evaluating contingent liabilities? Are contingencies reported in accordance with FASB Accounting Standards Codification No. 450?)
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39. Compare business strategies, marketing plans, and budgets to operating practices and results to assess the adequacy of long-range plans and the effect on the parent thrift.
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40. Review a finance subsidiary's operations to:
- Compare the actual results of the financing structure with the business plan and the cost/benefit analysis to determine whether the parent association's goals have been achieved.

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- Determine whether the cost of each issue increases the effective interest rate of the security above limits in the business plan.
 - Determine whether the parent association has considered what effect unforeseen increases in payoffs would have on the effective interest rate of the securities issues.
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COMPLIANCE

LEVEL I

41. Determine whether the related organization was established in accordance with applicable regulations and policies. (Has the subsidiary complied with OTS notification or application procedures?)
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42. Verify that the related organization engages in activities that are authorized by law, regulation, or other authority (i.e., OTS or FDIC approval).
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43. Confirm that the related organization(s) is properly included or excluded from the parent thrift's regulatory capital.
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44. Verify that transactions with affiliates are in compliance with § 563.41 and 563.43.
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45. Verify that extensions of credit to insiders are in compliance with § 563.43.
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46. Confirm that potential conflicts of interest have been accurately represented to the related organization's board of directors.

47. Determine whether corporate separation has been maintained:

- Determine whether the related organization and parent association share common officers and directors.
 - Determine whether transactions, accounts, records, and board minutes of the parent thrift and the related organization are kept separate.
 - Verify that each entity is held out to the public as a separate corporation and has separate offices, signs, and letterheads.
 - Determine whether services (and related compensation) between the parent association and subsidiary are detailed in a written agreement, and that borrowings from the parent thrift are covered by written loan agreements.
 - Ascertain whether there is any actual or potential litigation involving corporate separation and assess the effect on the parent thrift.
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LEVEL II

48. Verify that reported activities are consistent with actual activities.

49. Verify compliance with OTS approval orders, applicable regulatory requirements (i.e., consumer regulations, investment limitations, ownership requirements), policies and OTS agreements. (Regulatory requirements vary based on the type of subsidiary, its activities and whether the parent thrift is eligible for expedited treatment under § 516.1.)

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50. Perform the following additional review for finance subsidiaries to:
- Determine whether assets are being purchased from entities other than the parent association.
 - Determine whether the subsidiary is engaging in unauthorized arbitrage transactions.
 - Determine whether any unauthorized action has occurred that could cause holders of preferred stock to exercise voting rights.
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51. Confirm compliance with regulations pertaining to usurpation of corporate opportunity (§ 563.201) and restrictions on loan services (§ 560.30).

52. Determine whether financial losses have been incurred as a result of conflicts of interest.

53. Identify pending activities that could affect corporate separation.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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