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Do it Right When Lending to Insiders: A Guide to Regulation O

WHITE PAPER

ARNOLD & PORTER LLP



Beth S. DeSimone is executive vice president and general counsel of the bank holding company FNB United Corp. in Asheboro, North Carolina. She previously worked with Arnold & Porter LLP in Washington, D.C.



Tengfei "Harry" Wu is an associate in the financial services practice group of Arnold & Porter LLP in Washington, D.C.

Executive Summary

Bank directors and executive officers bring business to the institutions they serve, which often, if not always, includes their own banking business. At the same time, however, federal law restricts the ability of directors and their related interests to engage in business with the bank with which they are associated, particularly in obtaining loans and extensions of credit. These restrictions are primarily set forth in Section 22(h) of the Federal Reserve Act and Regulation O of the Federal Reserve Board, but they apply to all insured depository institutions by virtue of other statutory provisions. Reg O has heightened importance because the federal bank regulators have been focusing on insider lending issues, and violation of these rules can carry personal liability to a bank director, as well as liability to the institution. Thus, it is important for bank directors to understand what Regulation O restricts and does not restrict and how to comply with it.

This article provides an overview of the requirements of Regulation O, also known as "Reg O," and where its restrictions may particularly impact a bank director and other insiders.

Scope of Regulation O

To understand the scope of Regulation O and its restrictions on "insiders," a director first should understand who is considered an "insider" and then what types of activities would be considered covered by the restrictions.

Insiders Covered by Regulation O

In general, Reg O defines an "insider" as an executive officer, director or principal shareholder of a bank or its affiliates, and includes any "related interest" of such a person. Some of the Reg O requirements apply to insiders of a bank and its affiliates (i.e., the bank's parent holding company or any other subsidiary of that holding company), while others apply only to insiders of the bank.

Regulation O defines an "executive officer" of a bank or an affiliate of the bank as a person "who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions" of the bank or the affiliate. Regulation O presumes that the chairman of the board, the president, every vice president, the cashier, the secretary and the treasurer are executive officers, but any of these officers can be taken out of the definition of "executive officer" if the employer of the officer excludes him or her, by resolution of its board of directors or by its bylaws, from participation in major policymaking functions, and the officer in fact does not participate in such functions. These provisions can act to narrow the universe of executive officers who are covered by Regulation O, but an officer so excluded may not participate in major policymaking functions of his or her employer, which makes such exclusion impractical for those officers with important responsibilities.

A "director" is a member of the board of directors. A "principal shareholder" generally means an individual or company that owns more than 10 percent of a class of voting securities of a bank or an affiliate of the bank, except that the term does not include the bank's parent holding company. Extensions of credit to a bank's parent holding company are governed by Regulation W of the Federal Reserve Board, however. Shares owned by an individual's immediate family are attributed to the individual.

Perhaps the most important definition in Regulation O, and one that directors in particular have to consider, is "related interest." A "related interest" of a person is a company (which can be a corporation, partnership or any other form of business entity) controlled by that person or a political or campaign committee controlled by or benefiting that person. A company is controlled by a person if the person owns at least 25 percent of any class of voting securities or controls the election of a majority of the directors of the company. In addition to these objective standards, a company can be found to be controlled by any person who has the "power to exercise a con-

trolling influence over the management or policies of the company." Furthermore, a person owning more than 10 percent of any class of voting securities of a company is presumed to have control over the company if the person serves as an executive officer or director of the company or no other person owns a greater percentage of that class of voting securities. An extension of credit to any related interest of an insider is treated as an extension of credit to the insider. For example, if a bank director is the general partner of a limited partnership that operates a local grocery chain, the grocery chain is considered a related interest of the director, and any loans the bank makes to the grocery chain will be aggregated with those made to the director in determining compliance with Reg O.

Extension of Credits Covered by Regulation O

Regulation O also has an expansive definition of "extensions of credit" to which its restrictions apply. Specifically, an "extension of credit" is defined to cover not only common loans and lines of credit but also any transaction "as a result of which a person becomes obligated to pay money (or its equivalent) to a bank." For example, if a bank issues a standby letter of credit on behalf of a business owned by a bank director, that is considered an extension of credit to the insider. There are several exclusions from this broad definition, however. For example, a line of credit up to \$15,000 under a bank credit card program that is available to the general public, or an overdraft of up to \$5,000 under a written, pre-authorized, interest-bearing overdraft credit plan, is not considered an extension of credit.

The Dodd-Frank Wall Street Reform and Consumer Protection Act further broadens the definition of "extension of credit" to include credit exposure that arises from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction. As a result, if a transaction between a bank and an insider gives rise to such credit exposure, the restrictions of Regulation O apply. This expanded definition will become effective on July 21, 2012. Reg O also contains a rule to prevent evasion. Under

this rule, an extension of credit is considered made to an insider "to the extent that the proceeds are transferred to the insider or are used for the tangible economic benefit of the insider." An exception from the rule applies where the extension of credit is made on market terms and the proceeds are transferred to an insider in a bona fide transaction to acquire property, goods or services from the insider. This exception allows a bank to extend credit to customers of insiders in the ordinary course of business without implicating Regulation O.

Restrictions on Extensions of Credit

Regulation O sets forth two tiers of restrictions on extensions of credit by a bank to insiders. The first tier generally applies to all insiders of both the bank and its affiliates, whereas the second tier applies only to executive officers of the bank. In prescribing these restrictions, Regulation O imposes compliance obligations not only on banks, but also on the insiders themselves. Thus, in addition to prohibiting banks from extending credit in violation of Regulation O, it provides that no insider of a bank or any affiliate may knowingly receive, or knowingly permit, any of that insider's related interests to receive any extension of credit that constitutes a violation of Reg O. An insider that violates Reg O is subject to personal liability and civil monetary penalties, as is the bank itself. If a bank becomes troubled and goes into receivership, Regulation O violations tend to be one of the easiest allegations to make against the former board members, and regulators often go after them.

Restrictions Applicable to All Insiders

The following restrictions apply to extensions of credit by a bank to any insider of the bank or its affiliates (including all related interests of the insider):

(1) Arm's Length Terms and Creditworthiness

Generally, if a bank extends credit to an insider, it must do so on substantially the same terms, and follow the same credit underwriting procedures, that the bank applies to non-insiders and non-employees.

There is one exception to this rule, which allows an insider to be offered preferential terms that are generally available to non-insider employees as part of a benefit or compensation program. For example, if a bank waives certain mortgage fees for all bank employees, it may also waive such fees on a mortgage loan made to the bank president.

(2) Lending Limits

Second, the aggregate amount of credit that a bank extends to any insider must not exceed the bank's legal lending limit. However, given the sensitivity of the regulators to affiliate and insider transactions, it would be a best practice and prudent for most institutions to restrict this amount to the bank's internal limit on loans to any one borrower or even lower. Furthermore, the aggregate amount of credit that a bank extends to all insiders must not exceed the bank's unimpaired capital and unimpaired surplus. Certain secured or recourse lending does not count toward the aggregate lending limit for all insiders.

(3) Prior Approval

Third, any extension of credit by a bank to an insider which brings the aggregate amount of credit extended to the insider above \$500,000, or above the greater of \$25,000 or 5 percent of the bank's unimpaired capital and unimpaired surplus, must be approved in advance by a majority of the entire board of directors of the bank. The insider may not participate in the voting.

(4) Prohibition on Payment of Overdrafts

Fourth, a bank may not pay an overdraft of an executive officer or director of the bank or an affiliate of the bank on an account at the bank, unless the payment is made in accordance with a written, preauthorized, interest-bearing extension of credit plan that specifies a method of repayment, or a written, preauthorized transfer of funds from another account of the director or officer at the bank. This prohibition helps to ensure that extensions of credit to directors or officers are documented and moni-

tored, and not disguised as overdrafts to circumvent the lending limits and prior approval requirements. Unlike the restrictions described above, this prohibition does not apply to a principal shareholder of the bank or an affiliate (unless that person is also a director or executive officer); nor does it apply to any related interests of an insider. Furthermore, there is an exemption for inadvertent overdrafts of \$1,000 or less, if the account is not overdrawn for more than five business days, and the bank charges market-based fees for the overdraft.

An exemption from all the above restrictions is available for a director or executive officer of an affiliate of the bank if the bank, by resolution of its board of directors or its bylaws, excludes the director or executive officer of the affiliate from participation in major policymaking functions of the bank, and the director or executive officer in fact does not participate in such functions. This exemption is not available, however, to directors and executive officers of the bank's parent holding company, or those of an affiliate that accounts for more than 10 percent of the consolidated assets of the parent holding company.

Restrictions Applicable to Executive Officers of a Bank

The amount of credit that a bank may extend to an executive officer depends on the purpose of the officer's borrowing. A bank may extend credit to an executive officer, subject to the lending limits discussed above, if the credit is used:

- to finance the education of the officer's children; or
- to finance or refinance the officer's residence, on which the bank obtains a first lien mortgage.

If the credit is extended for any other purpose, the aggregate amount of credit extended to any executive officer may not exceed the higher of 2.5 percent of the bank's unimpaired capital and unimpaired surplus or \$25,000, up to \$100,000. An extension of credit does not count toward this limit, however, if it is secured by U.S. government obligations or

guarantees, or a segregated deposit account in the lending bank.

If one or more of a bank's executive officers, either individually or collectively, hold a majority interest in a partnership, the total amount of credit extended by the bank to the partnership is considered to be extended to each executive officer who is a partner of the partnership for purposes of the lending limit to each executive officer. For example, if two executive officers of a bank together own a 51 percent interest in a partnership, any loan that the bank makes to the partnership will be aggregated with the loans made to each of the two officers. Accordingly, if the bank may lend up to \$100,000 to each executive officer but one of the officers already has an \$80,000 unsecured loan from the bank, the bank may not lend more than \$20,000 to the partnership unless any excess amount is secured as required.

An extension of credit by a bank to any of its executive officers is subject to the following additional conditions:

- it must be promptly reported to the bank's board of directors;
- it can be made only after the executive officer submits his or her detailed current financial statement; and
- the bank must have the option, as set forth in writing, that it may declare the loan due and payable at any time that the executive officer's aggregate borrowings from any other bank or banks exceed any limit discussed above.

Recordkeeping Requirements

Regulation O requires banks to maintain records to document compliance with its restrictions. The recordkeeping requirements include conducting an annual survey to identify all insiders of the bank itself. With respect to insiders of affiliates, it would be best for the bank to identify such insiders through the annual survey method, but Regulation O also permits the bank to identify such insiders by requiring each borrower to indicate whether the borrower is an insider of an affiliate of the bank. Regulation

O also permits the bank to use an alternative method to identify insiders of affiliates if the bank obtains approval for such a method from its primary federal regulator. The bank must then maintain records of the amount and terms of each extension of credit to an insider.

Conclusion

The restrictions of Regulation O can be complicated to navigate, but given their importance to the federal bank regulators in preventing insider abuse, it is important to understand and comply with the restrictions. Thus, banks and insiders should carefully review any potential insider transaction and seek legal guidance, if necessary, prior to entering into any transaction.