Bank Subsidiaries and Affiliates

These examination procedures were developed to provide examiners guidance regarding:

1. how to review bank subsidiaries and affiliates (including those that are not institution-affiliated parties (IAPs)) of an FDIC-supervised institution for compliance with consumer protection laws and regulations;
2. the information and documentation needed to determine whether an affiliate is an IAP; and
3. how to incorporate violations involving subsidiaries and affiliates in the Report of Examination (ROE).

These procedures should be used when, in the course of an examination, visitation, or investigation, examiners believe an affiliate or subsidiary of a state non-member bank may have violated fair lending or other consumer protection laws and regulations.

Background

FDIC examination authority over IAPs is derived from the Federal Deposit Insurance Act (FDI Act). The FDI Act permits examiners to examine affiliates of insured banks as needed to disclose the relationship between the bank and a given affiliate, as well as the effect of that relationship on the bank.[1] The term "affiliate" encompasses any company that controls, is controlled by, or is under common control with another company. Therefore, a subsidiary controlled by a non-member bank, whether wholly owned or not, is considered an "affiliate" of the bank[2] for purposes of the FDI Act.

The FDIC generally may only bring enforcement actions against insured state non-member banks and their IAPs.[3] Accordingly, while affiliates of FDIC-supervised banks should be reviewed in all cases, it is necessary to determine whether the affiliate qualifies as an IAP of the bank both in order to properly document violations of the affiliate in the ROE and to determine whether such violations can be pursued directly by the FDIC or must be referred to another agency.

Once a potential violation of a consumer protection law or regulation is discovered during the review of the affiliate's activities, then IAP status of the affiliate must be determined. An affiliate may be an IAP based on any one or more of the statutory bases set forth in section (u) of the FDI Act, 12 U.S.C. § 1813(u), where the term "institution-affiliated party" is defined as:

1. any director, officer, employee, or controlling stockholder (other than a bank holding company) of, or agent for, an insured depository institution;
2. any other person who has filed or is required to file a change-in-control notice with the appropriate Federal banking agency under section 7(j);
3. any shareholder (other than a bank holding company), consultant, joint venture partner, and any other person as determined by the appropriate Federal banking agency (by regulation or case-by-case) who participates in the conduct of the affairs of an insured depository institution;
4. any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in
   - any violation of any law or regulation;
   - any breach of fiduciary duty; or
   - any unsafe or unsound practice,

     which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution.

Most often, an affiliate or subsidiary of a bank could be an IAP:

- as an agent of the institution under subsection;
- as a consultant, joint venture partner, or "other person" participating in the affairs of the institution under subsection; or,
- less likely, as an independent contractor whose misconduct has caused serious loss to, or an adverse effect on the institution.

Examination Procedures

1. During the pre-examination process, an examiner should determine if the bank has an affiliate, and the relationship of that affiliate to the bank. Examiners should apply a risk-focused approach in determining if and to what extent an affiliate's activities should be reviewed. The scope of the review of affiliate activity will be preliminarily established during the pre-examination process and should be refined during the examination as a result of discussions held or the presence of significant issues or violations.
2. Regardless of whether an affiliate is an IAP or not, examiners should review affiliates of FDIC-supervised banks. Affiliate activity is considered under many aspects of the examination process, such as during the review of Non-Deposit Insurance/Investment Products, Privacy of Consumer Financial Information, Fair Credit Reporting Act, Third-Party Risk, UDAP, RESPA, Fair Lending, and CRA, if applicable. Applicable examination procedures should be applied to the various activities of bank affiliates. Transactional testing may be necessary using

1 12 U.S.C. § 1820(b)(4).

2 Hereinafter "affiliate" will include both subsidiaries (wholly owned or otherwise) and affiliates of the bank.

3 12 U.S.C. § 1813(u); 12 U.S.C. § 1818.

examination procedures for applicable consumer laws and regulations. If a review of the affiliate's activities results in no apparent violation or issue, then determination of IAP status is not necessary, and no further examination procedures apply.

3. Once an examiner identifies a potential violation of a consumer protection law or regulation during his or her review of an affiliate's activities, the next step should be to consult Legal to determine IAP status so that the FDIC can decide whether it has enforcement jurisdiction over the affiliate. An examiner initially should ascertain if this determination previously has been made (***e.g.***, during a prior compliance or risk management examination). If so, verify that the facts relied upon in making the prior determination remain substantially unchanged. If a determination previously has not been made, the process of determining IAP status should begin as soon as a potential violation is discovered, but should not hold up the examiner's review if discovered prior to the determination.
4. If apparent violations exist and no IAP determination previously has been made, then during the examination proper documentation should be gathered to determine the relationship of any affiliates and the bank utilizing the guidance below. The Region should consult the Legal Division early in the process to discuss and determine which of the areas outlined below would be most fruitful in determining whether the affiliate is an IAP and in identifying the additional information or documentation necessary to support an IAP status determination.

   The first and most important step in the analysis of IAP status is to fully understand the relationship between the bank and its affiliate with regard to its operations and its structure. Analysis of IAP status is fact-specific and can be complex. This includes, among other things, the extent to which the affiliate is involved in the activities of the bank. IAP determinations can also require an in-depth analysis of the effect of the affiliate's operations on the bank's financial stability and viability.

   As a threshold matter, identify the asset size of the bank and the asset size of the affiliate. As you gather the information and documentation below, keep in mind that no single fact or element will prove institution affiliated or non-affiliated status.

   - **What is the legal relationship between the bank and the affiliate?**
     - What is the contractual relationship between the bank and the affiliate?
     - Are the bank and the affiliate under common control (***e.g.***, under the same holding company structure)?
     - How much of the affiliate is owned by the bank? (***e.g.***, Is it a wholly owned subsidiary? If not, does the bank have a majority or minority interest? What is the bank's ownership percentage of interest? What is the amount of the bank's investment?)
   - **What is the management relationship between the bank and the affiliate?**
     - Does the composition of the board of directors of the affiliate mirror or overlap with the board of directors of the bank?
     - Do the affiliate and the bank share management or employees? If so, are expenses for the affiliate's employees reflected on the bank's Call Report?
     - Does the affiliate influence or have the ability to affect bank policies, procedures, activities, or operations?
   - **What is the financial relationship between the bank and the affiliate?**
     - Has the bank funded affiliate loans either directly or indirectly through funding a revolving line of credit to the affiliate? If so, what are the amount and terms of the loan? Who else lends to the affiliate and what proportion of the outstanding credit comes from the bank versus outside sources? What is the ratio of the bank's total assets to the loan(s) or line(s) of credit to the affiliate?
     - What is the percentage of the bank's total net income that is derived from the affiliate services or accounts?
     - What effect would the failure or bankruptcy of the affiliate have on the bank? How closely is the bank's success linked to the affiliate's success?
     - Are customers referred between the bank and the affiliate? If so, on what basis? If so, what are the percentages of total referrals made and received by each entity, respectively?
     - If any customers are referred between the bank and affiliate, are any referral fees paid?
     - Are there any shared resources between the bank and affiliate (such as compliance consulting firms, audit firms, or marketing firms)?
   - **What is the professional relationship between the bank and the affiliate?**
     - What services does the affiliate perform for the bank?
     - Who prepares and files the HMDA LAR on behalf of the bank?
     - If the affiliate makes loans, does the affiliate file its HMDA LAR independently, or with the bank?

- Does the bank claim the affiliate's loans for CRA credit?
- What is the affiliate's involvement in developing the bank's loan program?
  - Does the affiliate develop the terms and conditions of the bank's loan program(s)? If so, to what extent does the bank participate?
  - Does the affiliate set underwriting standards for the bank (or vice versa)?
  - Who prepares marketing materials for the bank's loan programs? If the affiliate is involved, what is the level of the bank's oversight? To the extent that solicitation materials are reviewed for legal compliance, whose attorney does so? Who has final approval of the solicitation and marketing materials?
- What is the affiliate's involvement in loan processing?
  - To what extent does the affiliate receive loan applications, engage in underwriting activities, service loans, etc.?
  - Does the affiliate participate in credit decisions for loans originated by the bank? Are the decisions of the affiliate subject to review by the bank? What type of review does the bank conduct?
  - Who closes the loans? In whose name?
- What is the Bank's involvement in loan funding?
  - Who funds the loans?
  - What percentage of loans funded by the bank are originated by the affiliate?
  - If the affiliate focuses on one or a few loan categories, what portion of the loans the bank funds in those categories are originated by the affiliate?
  - To what extent do the bank and affiliate purchase loans from each other? What percentage of loans made by one entity are purchased by the other entity?
  - To what extent does the bank buy participation interests from the affiliate or vice versa? Are such purchases pursuant to an agreement?
- If the loans are sold to investors: 1) Does the bank guarantee any warranty obligation of the affiliate in the Loan Sale Agreement? 2) How are the participation interests, if any, transferred to investors?
- Are there any other facts or information that connect the affiliate with the bank, or that otherwise may be relevant?
- What is the physical proximity between the affiliate and the bank? Do they share office space? If so, is the space leased or provided at no cost to the affiliate? If not, are the offices in close proximity to each other?

- **How do the bank and the affiliate define their relationship to the public?**
  - Does the affiliate refer loan customers to the bank (and vice versa)?
  - Does the affiliate share the same website as the bank?
  - Does the website of the affiliate contain references or links to the bank (and vice versa)?
  - Who sends the bank's marketing materials to potential customers? In whose name are the materials sent?
  - Do the affiliate's marketing materials and solicitations reference the bank?
  - Do other public representations demonstrate a link between the bank and the affiliate?

Gathering Documents:

The following are examples of types of documents that may be relevant in conducting an IAP analysis. This list is not all-inclusive and examiners are encouraged to gather and consider any and all relevant documentation.

- Contracts or other written agreements between the bank and the affiliate;
- E-mails or other written correspondence between the affiliate and the bank relating to any services or programs conducted by the affiliate of the bank that are relevant in defining the relationship between the bank and its affiliate;
- Documentation relating to transactions conducted, and compensation arrangements between the affiliate and the bank;
- Policies governing the relationship between the affiliate and the bank and any other pertinent policies and procedures;
- Documents relating to marketing materials, transactions, loan terms and conditions, underwriting standards, and the extent to which the affiliate is involved;
- If the bank's website refers to the affiliate, a screen shot of that page, and other relevant pages, if any;
- If the affiliate's website refers to the bank, a screen shot of that page, and other relevant pages, if any;

- HMDA LARs;
- Organizational charts that show the relationship between the holding company (if any), the bank, and the affiliate;
- Officer and Director lists for bank and affiliate;
- Entity formation documents for the affiliate (Articles of Incorporation and Bylaws);
- For loans originated by the affiliate: investor contracts, including Investor Lock Agreements, Loan Sale Agreements and Guarantees with investors, to determine the bank's potential liability;
- Interview notes with bank management and the affiliate about the relationship between the two entities and how it works in practice (not just as written);
- Board minutes of bank and affiliate; and
- Any line-of-credit agreements with the bank or any entities with which the bank and/or affiliate both have credit lines (reflecting shared source of funding).

5. If the Region has conducted a review of the affiliate's activities and believes that a violation has occurred, in cases where a 15-day letter is appropriate, a 15-day letter must be sent to both the bank and the affiliate informing them of the preliminary finding and providing them an opportunity to respond. In instances where an affiliate is deemed not to be an IAP, and there is a potential fair lending violation, the FDIC must determine if the bank is liable on its ***own*** actions. Prior to sending the 15-day letter, the examiner must determine whether the bank participated in the credit decision for the loans at issue, and thus can be deemed a "Creditor" under the Equal Credit Opportunity Act (ECOA). Regulation B defines the term "Creditor" as a person who, in the ordinary course of business, regularly participates in a credit decision, including setting the terms of the credit (***i.e.*** did the bank establish the underwriting standards for the affiliate). The term "Creditor" includes a creditor's assignee, transferee, or subrogee who so participates. For purposes of ECOA's discrimination provision[4] and its discouragement provision,[5] the term "Creditor" also includes a person who, in the ordinary course of business, regularly refers applicants or prospective applicants to creditors, or selects or offers to select creditors to whom requests for credit may be made. A person[6] is ***not*** a "Creditor" regarding any violation of ECOA committed by another "Creditor" unless the person knew or had reasonable notice of the act, policy, or practice that constituted the violation before becoming involved in the credit transaction.[7] One of the primary purposes of this analysis is to determine whether the bank has any independent liability under ECOA.
6. The following applies: 1) in instances when a 15-day letter is not required, or 2) in instances when a 15-day letter has been sent and, after reviewing the response to the 15-day letter, DCP continues to believe that a violation has occurred. If the affiliate is an IAP, the violation should be cited in the ROE and enforcement action against the IAP directly should be considered. If the affiliate is deemed not to be an IAP, the FDIC will refer the case to the appropriate Federal agency with primary enforcement responsibility, such as the Federal Trade Commission (FTC), the Department of Housing and Urban Development (HUD) or the Board of Governors of the Federal Reserve System (FRB).
7. Regardless of the affiliate's IAP status, the violation should be documented in the ROE. Section 10(b)(5)(B) of the FDI Act requires that FDIC examiners make "a full and detailed report of condition of any insured depository institution or affiliate examined to the Corporation."
   - The examiner should include appropriate comments on the Examiner's Comments and Conclusion pages of the ROE. The comments should identify the specific affiliate and describe how that affiliate violated fair lending or other consumer protection laws and regulations.
   - The examiner should include a description of the affiliate's violation on the Violations page of the ROE. In situations where the affiliate is not an IAP, a summary should be included at the top of the Violations page explaining that because the entity is not an IAP, the FDIC will refer the matter to the appropriate Federal agency with primary enforcement jurisdiction over the entity. However, violations of affiliates, whether an IAP or not, should not be entered in SOURCE.
   - Whether or not the affiliate is an IAP, the bank remains responsible for robust oversight of third-party activities and quality control over those products and services provided through third-party arrangements, in order to minimize exposure to potential significant financial loss, reputational damage and supervisory action. Where a bank has failed to fulfill its oversight responsibility, and particularly where the bank has had prior notice of affiliate violations, the bank should be criticized for a lack of proper oversight and required to establish proper controls.[8]

4 12 C.F.R. § 1002.4(a).

5 12 C.F.R. § 1002.4(b).

6 "Person" means a natural person, corporation, government or governmental subdivision or agency, trust, estate, partnership, cooperative, or association. 12 C.F.R. § 1002.2(x).

7 12 C.F.R. § 1002.2(l). The regulation states that the term "Creditor" does not include a person whose only participation in the credit transaction involves honoring a credit card.

8 See FIL-44-2008 (Guidelines for Managing Third Party Risk).

- Whether or not the affiliate is an IAP, the bank's overall CMS and consumer compliance rating (and potentially CRA rating) should be reflective of the affiliate's violations.

8. All Regional and Washington Office consultation policies should be followed throughout bank subsidiary and affiliate reviews.

References

DSC RD Memo 10-016 Compliance Examinations of Bank Subsidiaries

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