

A blurred background image of a business meeting. Several people in professional attire are gathered around a table. One person is holding a tablet displaying a document with charts and text. Another person is holding a smartphone. A white coffee cup is visible on the table. The overall scene suggests a collaborative work environment.

Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks

Understanding Regulation O

July 18, 2024

Introduction to Regulation O

Definition: Regulation O is a Federal Reserve regulation that limits and stipulates the credit extensions a member bank can offer to its insiders.

Purpose: To prevent insiders such as bank directors, trustees, executive officers, or principal shareholders from receiving favorable credit extensions.

Application of Regulation O

Applies to: Executive officers, principal shareholders, and directors of member banks.

Reporting Requirements: Banks must report any credit extensions to insiders in their quarterly reports.

Restrictions: Ensures that insiders are not given more advantageous credit terms than non-insiders.

Insiders v. Related Interests

An “insider” is typically defined as an executive officer, director, or principal shareholder of a member bank. This includes individuals who have the ability to influence the management or policies of the bank, such as through ownership of a controlling amount of the bank’s stock.



A “related interest”, on the other hand, refers to a company or firm that is controlled by an insider. This could be a corporation, partnership, or other type of business entity. The control is usually established by ownership, by holding a position of influence, or by other means. A related interest is often associated with the insider in a way that could potentially influence the insider’s actions and decisions regarding the bank.



Regulation O imposes certain restrictions and reporting requirements on extensions of credit to insiders and their related interests to prevent conflicts of interest and ensure that transactions with these parties are conducted on market terms and do not pose additional risk to the bank



Regulation O and Overdrafts

There are specific restrictions on paying overdrafts for directors and executive officers of member banks. Here are the exceptions:

Exceptions:

1. **Written, Preauthorized Plan:** A bank may pay an overdraft for a director or executive officer only if it is done under a written, preauthorized, interest-bearing plan that specifies a method of repayment.
 2. **Transfer from Another Account:** An overdraft may be paid by transferring funds from another account of the director or executive officer at the bank, provided such transfer was pre-authorized in writing.
- **Overdrafts of \$5,000 or Less:** Overdrafts of \$5,000 or less are not considered extensions of credit if they are made pursuant to a written, preauthorized, interest-bearing extension of credit plan, or a written, preauthorized transfer of funds from another account.
 - These restrictions are in place to prevent conflicts of interest and ensure that insiders are not receiving unauthorized financial benefits. Violations of these restrictions can lead to the consequences mentioned earlier, including civil penalties and reputational damage.



Overdrafts and Related Interests

- The overdraft restrictions of Regulation O primarily apply to the accounts of directors and executive officers of member banks. However, these restrictions do not directly apply to the accounts of related interests.
- While Regulation O prohibits overdrafts in the accounts of directors and executive officers (subject to certain exceptions), it does not explicitly prohibit overdrafts in accounts of related interests. **Nonetheless, any overdrafts in the accounts of related interests would be considered an extension of credit and, therefore, subject to other Regulation O provisions regarding extensions of credit to insiders.**
- It's important to note that while the overdraft restrictions might not directly apply, the broader principles of Regulation O regarding fair and equitable treatment in credit extensions would still influence how a bank handles overdrafts for related interests to ensure compliance with the regulation's intent.



Regulation O Reporting Requirements

Under Regulation O, member banks are required to report certain overdrafts involving insiders and their related interests. Here are the key reporting requirements:

- **Quarterly Reports:** Banks must report any extensions of credit, including overdrafts, provided to insiders in their quarterly reports.
- **Annual Reports:** Executive officers and principal shareholders with outstanding extensions of credit from a correspondent bank must file a written report with the board of directors of the member bank annually.

Thresholds for Reporting: Overdrafts that meet certain thresholds, such as being large enough to require prior approval or exceeding a certain amount, must be reported. However, specific amounts of individual extensions of credit are not required to be disclosed.

These reporting requirements are designed to ensure transparency and prevent conflicts of interest by keeping the bank's board informed about potential insider transactions that could affect the bank's operations and risk profile.



Common Mistakes in Regulation O Compliance

- Preferential Terms: Offering preferential terms to insiders unless it's part of a bank-wide employee benefit program.
- Underwriting Standards: Not applying at least as stringent underwriting standards as for outsiders.
- Loan Approval: Failing to obtain prior board approval for loans exceeding \$500,000 to insiders.
- Paying overdrafts for Insiders

Consequences of non-compliance

Violating Regulation O can lead to significant consequences for both the individual insiders involved and the financial institution. Here are some of the potential repercussions:

- **Civil Liability:** Institutions and individuals may face civil liability, with fines of up to \$5,000 per day for each day the violation continues.
- **FDIC Penalties:** The Federal Deposit Insurance Corporation (FDIC) can impose penalties on financial institutions for insider abuse related to Regulation O violations.
- **Reputational Damage:** Violations can severely damage the public's confidence in the financial institution, potentially leading to a loss of business and a tarnished reputation.
- **Criminal Penalties:** In severe cases, there might be criminal penalties, including fines and imprisonment, for individuals involved in the violation.
- **Regulatory Actions:** Regulatory agencies may take actions such as cease and desist orders, removal of officers or directors, and enforcement actions against the bank.

It's important for financial institutions to maintain robust compliance programs to prevent and detect any potential Regulation O violations, thereby avoiding these severe consequences.

Conclusion

Summary of key points

- The Bank is held responsible for Regulation O Compliance.
- The Bank is at the mercy of its own directors and executive officers to make sure “The Bank” is informed of related interests and complies with Reg O.
- The Bank must not pay for any overdrafts incurred by Directors or Executive Officers.
- The Bank may not exempt or reverse fees which should be charged to Directors or Executive Officers.