

## **GENERAL INSTRUCTIONS**

These instructions provide general guidance for conducting field investigations and preparing the Report of Investigation (ROI). Since each application has unique characteristics and often involves special circumstances, examiners should consult the references below and discuss issues or questions with the appropriate Case Manager. The examiner should look beyond the surface of the proposal and address the likelihood of success or failure. The final report should be comprehensive, well supported, and address any atypical attributes.

## **REFERENCES**

Use the following reference material in preparing the ROI:

- The instructions contained herein
- Statement of Policy on Applications for Deposit Insurance (SOP)
- FDIC Rules and Regulations Part 303, Subpart B, Deposit Insurance, and Federal Deposit Insurance Act sections 5 and 6
- Section 19 of the FDI Act and the Statement of Policy for Section 19 of the FDI Act
- Statement of Policy Regarding use of Offering Circulars in Connection with Public Distribution of Bank Securities
- Statement of Policy on the National Historic Preservation Act of 1966
- Applicable State Statutes and Regulations
- Case Managers Procedures Manual
- DSC Manual of Examination Policies
- Examination Documentation (ED) Modules
- Electronic Data Processing Examination Handbook
- Outstanding Applications memoranda and directives
- Questions and Answers on Stock Benefit Plans
- Division of Insurance and Research (DIR) – Statistics on Depository Institutions
- Uniform Bank Performance Report (UBPR)
- DSC and Risk Management & Applications Section Websites

## **APPLICATION PROCESSING**

The FDIC is responsible for approving or denying all applications for deposit insurance, regardless of the type of institution or fund affiliation. In addition to proposed state nonmember banks, mutual savings banks, and industrial banks, the FDIC acts on any application for deposit insurance from a proposed national bank, member bank, district bank, trust company, Federal or State savings association, or savings and loan. Applications for de novo institutions are filed with the chartering authority and the FDIC using the *Interagency Charter and Federal Deposit Insurance Application*. To ensure interagency applications go smoothly, examiners should contact the chartering agency as soon as possible to coordinate a joint field investigation and reduce regulatory burden.

Generally, examiners should attend any pre-filing or other meetings held by the chartering agency with the applicant. Application processing timelines vary among the banking agencies, therefore close coordination with the chartering agency is necessary. Duplication of work should be avoided such as conducting background checks on proposed officers and directors. Normally, in an application for a thrift or national bank charter, the OTS or OCC conduct the background checks.

## REPORT OF INVESTIGATION PROCEDURES

Reports of Investigation often vary in content and structure and emphasis should be placed on producing a well-conceived final product rather than following any strict format. The Statement of Policy on Applications for Deposit Insurance (SOP) is the primary source document for the factors that should be considered during the investigation. These guidelines are designed to assure uniform and fair treatment to all applicants.

Examiners should review the entire application and business plan to identify potential problems, incomplete or inconsistent information, areas of non-compliance with the SOP and/or Federal and State banking statutes, and any other factors which will require additional attention. It is important to identify, early on in the process, any concerns that will require significant attention to ensure that they do not delay the timely processing of the report. Subject Matter Experts in areas such as Consumer Compliance, Information Systems, Trust, Capital Markets, and Specialized Lending should be involved in the investigation when deemed necessary to adequately assess a proposal.

**Examiners should be aware that proposals not conforming to the SOP are not delegated to the Regional Office and will be forward to the Washington Office for final action. Further, applications involving foreign ownership of 25% or more (foreign ownership includes ownership by a foreign non-banking entity, a foreign bank, or person who is not a citizen of the United States) are also forward to the Washington Office for final action.**

After a thorough review and Regional Office concurrence, examiners should contact the organizers to discuss the specific issues and request any additional information. The examiner should hold a board meeting with proposed directors and senior officers. At a minimum, the meeting should include a discussion of the FDIC's expectations regarding director supervision, conduct and ethics. A sample agenda with suggested topics is found in Appendix A. The organizers and proposed directors should be individually interviewed to determine the extent of their understanding of the responsibilities they are taking on as directors, their abilities to execute the business plan and their commitment to the proposed bank. A sample Management/Director Interview form is found in Appendix A.

Examiners should not discuss the probable outcome of the investigation with the applicants.

## STATUTORY FACTORS

Sections 5 and 6 of the FDI Act specifically deal with the granting of deposit insurance. Section 6 identifies seven statutory factors that must be considered by the FDIC in determining the merits of an application. Those factors include:

1. Financial history and condition;
2. Adequacy of capital;
3. Future earnings prospects;
4. General character of management;
5. Risk presented to the insurance fund;
6. Convenience and needs of the community;
7. Consistency of corporate powers.

The Report of Investigation should detail the relevant facts pertinent to each of the statutory factors and state the examiner's opinion as to whether the criteria under each area has been met. Findings of Favorable Subject to the Imposition of Conditions are permissible if the reasons for such a finding are clearly supported. Narrative comments should fully support any negative finding and when possible, identify any corrective action that, if taken, would favorably resolve the concerns. Examples could be issues such as finalizing blanket bond coverage, obtaining an appraisal on the premises, finalizing stock sale, etc.

While all factors are important and must receive a favorable finding, the FDIC considers Management and Capital as being the two most important factors. The Investigation Report Conclusions and Recommendations page should include a description of the proposal, a summary of each factor, and an overall recommendation relative to the granting of insurance.

## MISCELLANEOUS REPORT ISSUES

Generally, the public may inspect the non-confidential portions of an application. While the burden is on the applicant to request confidential treatment of certain application material, the following areas are generally considered confidential:

1. Personal information, the release of which would constitute a clearly unwarranted invasion of privacy;
2. Commercial or financial information, the disclosure of which would result in substantial competitive harm to the submitter; and
3. Information the disclosure of which could seriously affect the financial condition of any depository institution.

The public may obtain photocopies of non-confidential material through a Freedom of Information Act request and by an oral or written request to the Regional Office.

Financial numbers are rounded to the nearest thousand.

## COVER – REPORT OF INVESTIGATION

Insert complete name of proposed bank, city, county, and state.

Insert Region, EIC, and type of charter.

- Date investigation commenced would be the date review began in the field office.
- Investigation closed date is date the report was mailed to Regional Office.
- Date of application is obtained from the application.
- Date application accepted is found on ViSION's Application Tracking (AT).

## TABLE OF CONTENTS

The table of contents identifies the three major report sections: Conclusions and Recommendations; Assessment; and Other Information. Completion of all pages is mandatory. Examiners may create and add pages under each factor if it supports their conclusions and recommendations.

## INVESTIGATION REPORT CONCLUSIONS AND RECOMMENDATIONS

This page should summarize the proposal with enough details to give the reader a complete understanding of the transaction. The investigating examiner should provide a brief summary of the proposed business plan under the "Description of the Transaction" heading. Each statutory factor and finding of Favorable, Unfavorable, or Favorable Subject to Conditions should also be summarized. The investigating examiner should conclude with an overall recommendation.

**FINANCIAL HISTORY AND CONDITION**

Generally, proposed financial institutions have no financial history to serve as a basis for determining qualification for deposit insurance. Therefore, the primary areas of consideration under this factor are the reasonableness of asset and liability projections and composition in relation to the proposed market, the level of investment in fixed assets, the ability of insiders to provide financial support to the institution, terms upon which transactions with insiders are granted, and whether adequate disclosure of insider transactions has been made.

- Assess the applicant's projected asset and deposit mix for reasonableness and as compared to the proposed business plan and an appropriate peer group.
- Using the financial statements contained in the business plan, construct the projected balance sheet for the first three years of operation. Discuss with the applicant, significant differences between the proposal's projections and yours. If necessary, the applicant should revise the projections. Projections that are not reasonable or unsupportable should lead to an unfavorable finding.
- Total direct and indirect fixed asset investment (including leases) should be reasonable in relation to projected earnings capacity and capital levels. A brief review should determine if the figures provided by the proponents are reasonable with regard to anticipated need and cost. Fixed asset schedules from other newly formed institutions can be used as a point of reference. Compliance with State law should be considered since most states impose a statutory limit on fixed asset investment relative to either capital or total assets.
- When real estate is to be purchased and a building constructed, the investigating examiner should review the cost of the land, estimated construction costs, the identity of the seller and general contractor, completeness of the title policy, and terms of any financing obtained. Part 323 of the FDIC Rules and Regulations is applicable to the purchase of real property, including leaseholds, and a qualifying appraisal is usually required. For leased premises, the terms and reasonableness of the lease should be discussed. Applicants are generally cautioned against purchasing any fixed assets or entering into any non-cancelable construction contracts, lease or other binding arrangements related to the proposal unless and until the FDIC approves the application.
- Any time assets are purchased or leased from insiders or when insiders are involved in providing contracted services, the transactions should be supported by an independent appraisal or competitive bid process. The organizers must substantiate that any transaction with an insider is made on substantially the same terms as those prevailing for comparable transactions with non-insiders and do not involve more than a normal degree of risk. Such transactions must be intended for the benefit of the institution and not entered into as an accommodation to the insider. All such transactions must also be approved in advance by a majority of the incorporators and fully disclosed to all proposed directors and shareholders.
- Organizers, including an affiliated holding company, must demonstrate the ability to provide on-going financial support. Analyzing the ability of the proponents to raise additional capital is important since new banks (operating at a loss) will often experience difficulty in attracting capital from outside sources. Analysis of this will be primarily dependent upon the financial statements submitted by the proponents or Uniform Bank Holding Company Reports when a holding company is involved. If reasonable, consideration should be given to the ability of the proponents to raise additional funds through the capital markets or the local community.
- Assess compliance with the security requirements of Part 326 of the FDIC Rules and Regulations.
- Assess compliance with the National Environmental Policy Act of 1969. The FDIC is responsible for making a determination whether certain decisions made by it constitute "major Federal actions significantly affecting the quality of the human environment" under this Act. Granting of approval for deposit insurance seldom constitutes a significant action requiring an environmental impact statement, but a threshold determination as to the probable effect upon the human environment must be made under the statute. The environmental factors to be considered include: (a) compliance with local zoning laws; (b) location; (c) traffic patterns including the

adequacy of roads, parking places and traffic congestion; and (d) any favorable impact such as possible decrease in pollution or fuel consumption.

Compliance with zoning laws is generally the key determining factor for the FDIC since courts have ruled that compliance is an assurance that such environmental effects will be no greater than demanded by the residents acting through their elected representatives.

- Section 106 of the National Historic Preservation Act (NHPA) requires that a Federal agency having authority to license any undertaking shall, prior to issuing any license, take into account the effect of the undertaking on any district, site, building, structure, or object that is included in, or eligible for inclusion in, the National Register of Historic Places (National Register).

At the time of filing an application for Federal deposit insurance, the proponents should have already been in contact with the appropriate State Historic Preservation Officer (SHPO) regarding whether the proposed main office (as well as any branch office) site is an historic property - that is, listed in, or eligible for listing in, the National Register. The FDIC generally relies on the SHPO's opinion regarding whether the proposed office site is historic and, if it is, what effect the Federal deposit insurance proposal will have on the property. If it is determined that the proposal will have an adverse effect on an historic property, then the FDIC (usually the RO staff) must work with the proponents, the SHPO, other consulting parties, and, in some cases, the Advisory Council, to develop and evaluate alternatives or modifications to the undertaking that could avoid, minimize, or mitigate the adverse effect.

**It is very important that the examiner advise the proponents that absolutely no site preparation work should be initiated until SHPO has been consulted and a determination has been made regarding whether the proposed office site is historic and, if it is, what effect the proposal will have on the historic property.**

For Federal deposit insurance applications that involve establishment of a new national bank or thrift, for which a charter application has been filed with the OCC or OTS, the FDIC may not have to determine whether the proposed office site is historic and how the proposal will affect an historic property, if the primary Federal regulator has assumed this responsibility. The examiner or the Case Manager should contact their counterparts at the Federal chartering authority in order to ascertain which agency will be responsible for complying with the requirements of the NHPA.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

## ADEQUACY OF THE CAPITAL STRUCTURE

Normally, initial capital of a proposed institution should be sufficient to provide a Tier 1 capital to assets leverage ratio of at least 8% throughout the first three years of operation. In addition, the institution must maintain an adequate allowance for loan and lease losses. This means that the proposed institution **can not** inject the capital as it grows. Opening day capital must be sufficient to maintain at least an 8% Tier 1 Leverage ratio based on the three-year projections. Exceptions apply to new institutions formed by an eligible holding company (See section 303.22).

The adequacy of capital is closely related to the new bank's risk appetite, its deposit volume, fixed assets, and anticipated growth. Deposit projections made by the applicant must be fully supported and documented. Projections should be based on identifiable patterns in the target market. Special purpose institutions (such as credit card banks) should provide initial capital commensurate with the type of business to be conducted and the potential for growth of that business. Additional discussion of unique capital proposals such as contribution of in-kind capital as part of initial capitalization, and capital adequacy of new institutions organized to facilitate and carry on an existing business line is presented below. Examiners are reminded that these types of proposals and others presenting a higher risk profile may warrant a leverage capital ratio greater than 8%.

- Using capital data contained in the application, construct the Proposed Capital Structure table.
  - “Minimum Statutory Requirements” line should include any minimum capital required by the chartering agency.
  - “Amount indicated on Application” should reflect capital allocations shown in the application excluding any adjustments made by the examiner. All components of this line should be based on applicant’s projections.
  - “Revised Proposal” line is used only when the organizers present a revised capital proposal.
  - “Recommendation of Examiner” line may or may not be the same as applicant’s proposal; however, it must agree with final projections used throughout the report.
  - “Retained Earnings” column is the cumulative 3-year net income.
  - “Third Year Average Assets” column comes from the business plan projections and examiner’s estimates.
- The examiner should assess the deposit forecasts and make any necessary adjustments. The proponents should have a good feel for the deposit potential of their market. However, if growth projections are inconsistent with the size of the market, with current economic conditions, or with the overall business plan, adjustments should be made along with the examiner’s rationale. Examiners could consult any number of sources including the Uniform Bank Performance Report and DIR’s Statistics on Depository Institutions, for supporting data.
- If available, review the stock offering circular, stock solicitation material and related documents. The Washington Office’s Registration, Disclosure and Securities Operations Unit normally reviews both private and public offering materials and is available for assistance. All stock of the same class should be offered at the same price, and have the same voting rights. Arrangements that give insiders greater rights or more favorable pricing are not acceptable. A price disparity may allow organizers to gain control disproportionate to their investment and may promote excessive risk taking. In addition, such arrangements are analogous to compensating or paying a fee to organizers solely for their efforts in establishing the institution. Stock price disparities may also be used to hide excessive reimbursement to organizers. Another example of price disparity is offering stock warrants to investors who purchase a large volume of shares in the stock offering. Closely assess the appropriateness of stock offerings that award incorporators warrants to acquire additional shares. Stock warrants to insiders or investors that are beyond the guidance contained under the management factor of the SOP are not acceptable.
- If the institution is being established as a wholly owned subsidiary of an eligible holding company (as defined in part 303, subpart B) consider the financial resources of the parent organization in assessing the adequacy of the initial capital. In some cases, DSC may find favorably with respect to the capital factor when initial capital is sufficient to provide a Tier 1 leverage capital ratio of at least 8% at the end of the first year of operation, based on a realistic business plan, or initial capital meets the \$2 million minimum standard set in the SOP, or any minimum standards established by the chartering authority, whichever is greater. The holding company must also provide a written commitment to maintain the Tier 1 leverage ratio at no less than 8% throughout the first three years of operation.
- Stock financing arrangements by proposed officers, directors, and 10% shareholders should be carefully reviewed. Financing arrangements are only acceptable if the investor can clearly demonstrate the ability to service the debt without undue reliance on dividends or other forms of compensation from the new institution. Normally the direct or indirect financing of 75% or more of the purchase price by an individual or the financing of 50% of the purchase price by all insiders in the aggregate will require supporting justification. Ensure that the applicant bank did not agree to maintain compensating balances with the lender in order to procure financing. Also, the proponents should be made aware that such loans can not be refinanced by the applicant bank.
- Watch for voting trust arrangements. Generally, these agreements are discouraged in new banks because of control issues (insiders gaining control disproportionate to their investment), but are not prohibited per se. Review the agreements for any unfavorable features, such as control issues, or hampering sale of additional stock. Examiners should consult with the case manager and/or a regional attorney to obtain additional guidance.

- The stock subscription list should be reviewed to ensure that control issues have been identified and resolved, and to determine the likelihood of a successful offering.
- Cash dividends during the first three years of operation should only be paid from cumulative net operating income and only after an appropriate allowance for loan and lease loss has been established and overall capital is adequate.

**Unique capital proposals and capital for institutions organized to facilitate and carry on existing business lines.**

The SOP is silent on the issue of organizing an institution with in-kind capital. Likewise, it does not address how the FDIC will assess proposals that entail a new institution organized to facilitate and carry on an existing business line. Nonetheless, the FDIC has been presented with applications containing both proposals. In-kind capital contributions have been in several forms including, but not limited to, real estate, fixed assets, loans, leases, and mortgage banking operations. Existing business lines proposed in prior applications included equipment lease financing, credit card operations, and mortgage banking operations. These proposals present unique risks deserving close scrutiny. Examiners should also evaluate possible 23A and 23B implications and limitation from Part 325 capital calculation. The following points address prior instances where in-kind capital and existing business lines were part of applications.

- In applications where the FDIC will not be the primary regulator, the examiner should participate in the primary regulator's investigation.
- When loans or leases are proposed to be contributed as initial capital, the examiner should conduct a review of the loans and leases comparable to that completed during a traditional safety and soundness examination in order to assess asset quality. The sample should be large enough to assess loan or lease mix, underwriting standards, valuation and residual values, and proper documentation. Valuations should be supported by proper market value analysis such as discounted cash flow analysis. The examiner should strive to obtain an independent physical inspection of the assets in the sample. In lieu of a physical inspection, the examiner may rely on an independent audit confirmation of the assets in question.
- Tangible assets such as real estate and fixed assets contributed as part of initial capital present two main questions: valuation and insider involvement.
  - In the case of real estate, organizers must have an independent appraisal performed by certified or licensed appraisers (see Part 323 of the FDIC Rules and Regulations). The appraisal should conform to generally accepted appraisal standards and arrive at a fair market value. Fixed asset values should be supported by independent market valuations performed by experienced appraisers. Review the appropriateness of scheduled depreciation. A longer than normal depreciation period could overstate book value and earnings. Total fixed asset investment must also conform to State limitations.
  - Transactions involving organizers, directors, officers, or principal shareholders (insiders) should be closely reviewed to determine fairness and proper disclosure. For example, a contribution of bank premises under construction by an insider or related interest should not contain unfavorable features. Proper disclosure to other shareholders, written construction contracts based on a competitive bid process, and independent appraisals should be required.
  - In-kind capital contributions may be proposed in the form of the market value of an existing business such as a mortgage company. Proposals such as this should be fully supported by at least two appraisals of the company's fair market value. Examiners should ensure that the appraisals are independent, current (within 6 months) and based on recognized valuation methods.

Proposals for new institutions organized to facilitate and carry on an existing business line also provide special capital considerations. Contribution of the business as initial capital may or may not be a part of the proposal; however, recent cases have contained both. These include:

- An institution organized with a leasing company to provide equipment lease financing.
- An institution partly capitalized with seasoned auto loans, specializing in direct purchase of dealer-originated auto loans and from an affiliate credit finance company.
- An institution formed by an energy company, capitalized with in-kind contribution of consumer loans and will specialize in providing loans for energy-related home improvements.
- An institution formed by a farm equipment retailer to acquire its credit card receivables and continue origination and servicing company branded credit cards.
- An institution formed by a company that provides capital lease financing for small to medium sized businesses over the Internet. New bank to provide retail funding and lease financing.

Examiners should look to the prior performance of the business and the character of the management continuing on with the institution. The management group should be sufficient to satisfy the management factor. The business line should be financial in nature, and not expose the institution to undue risk. The business plan should be reasonable and the projections should be well supported by historical performance and sound analysis. Examiners should use all available information such as Dun & Bradstreet reports, SEC filings, independent audit reports, public recordings, and credit rating agency reports to verify data. If deemed necessary, an on-site visit to review the existing business' operations should be conducted.

When assets are proposed to be contributed as capital or purchased from organizing group or affiliate, values should be supported by independent appraisals. Asset quality should be assessed the same way credit reviews are conducted, i.e. sample by risk, volume, delinquency, underwriting, etc (refer to ED risk focus modules). If the business has not had a recent audit, or credit or collateral documentation is not complete, an independent verification or inspection of assets should be obtained.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

## **EARNINGS PROSPECTS**

Construct the "Estimated Income and Expense", and the "Estimated Average Deposits and Average Earning Assets" schedules using the financial statements contained in the Business Plan.

The examiner should determine whether the proposed bank is likely to be profitable within a reasonable period of time, usually three years. The main concern is whether the applicant's projections are realistic and supportable. The earnings should be sufficient to provide an adequate profit. When projections are not reasonable or deficiencies are material, revisions should be requested from the proponents. Examiner-derived estimates can be incorporated into the report; however, comments should clearly address the differences between the examiner's estimates and those of the organizers. Common shortcomings in projections include, but are not limited to:

- Unreasonable earning asset yields
- Unreasonable interest expense factors
- Overstated earnings factors (NIM, ROAA)
- Underestimating data processing costs
- Understated overhead costs
- Inadequate loan loss provisions
- Failure to write-off organizational expenses during the first year of operations

Items to be considered include projected loan growth relative to other new banks and that of competing institutions, likely structure of the deposit base, investment objectives, estimated asset and liability mix, reasonable noninterest



income, and probable provision expense. Consideration should also be given to ensure consistency with other projections such as deposit growth and personnel expense. Projections and assumptions should be consistent with the overall business plan.

The UBPR generally provides sufficient data to assess the line items contained in the projections. Financial data from recently formed institutions should prove to be the most beneficial. Peer data is also available for all new banks established within three years and under \$50 million in assets. Peer data for established community banks also warrants review especially when serving the same general area or market niche. Examiners should be aware that using peer ratios of established banks might result in some differences since new banks generally have a larger percentage of assets funded by capital. This results in higher margins during the early years. Examiner's selection and use of Peer data should be fully discussed and supported.

Loan loss provisions should be closely reviewed. Niche or special purpose banks that engage in higher risk lending, such as subprime loans and high loan to value lending, should fully support their loan loss reserve methodology, estimated losses and provisions. The methodology should account for replenishing the reserve to an adequate level after charge-offs.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

## **GENERAL CHARACTER OF MANAGEMENT**

Management is often the most important factor. Although the SOP indicates that evidence should support a management rating tantamount to a "2" rating or better under the Uniform Bank Rating System, this is somewhat difficult to determine without an operating record as a management team. As a result, the assessment of management should center on an evaluation of the individual's background in relation to their proposed duties and responsibilities. Consideration should be given to the following:

- Financial institution experience
- Other business experience
- Personal and professional financial responsibility
- Track record for honesty and integrity; and
- Familiarity with the economy, banking needs, and general character of the community in which the bank will operate.

Examiners should provide an overall assessment of the management team and board of directors on the General Character of Management page. Address each proposed officers and directors' qualification on the biographical section of the report. Comments should also include any prior experience that may reflect positively or negatively on the individual, any serious business failures or compromising of debts and length of residence in the community or trade area. All entities in which the proposed officer or director has a financial or other significant interest should also be identified.

The examiner should normally conduct personal interviews with all of the organizers, senior management, and directors. Any pertinent information derived should be included with the individual's biographical information. Current and former employers may also be contacted unless a prospective officer raises a valid objection (current employers may not know officer is seeking other employment and contacting them may cause the officer harm). Prior employer's concerns over privacy laws, however, may prevent them from divulging much information. At a minimum, a former employer should be able to tell you the individual's title, and whether the individual is eligible for rehire.

The biographical and financial information (FDIC 3064-0006, Interagency Biographical Financial Report) submitted as part of the application serves as the primary tool in assessing financial standing and responsibility. All questions should be answered and fully supported. These forms should disclose any prior bankruptcies or the compromise of

any debt. The forms should also include information on contingent liabilities, civil litigation, prior criminal convictions, administrative proceedings, and other matters involving a breach of trust.

A section 19 application will be necessary if an employee, officer, director, controlling shareholder or Institution Affiliated Party has been convicted of a criminal offense involving dishonesty or breach of trust, money laundering or has entered into a pretrial diversion in connection with a prosecution of such an offense. The Applicant must obtain the FDIC's written consent under section 19 of the FDI Act before any such person may serve in one or more of those capacities.

Significant assets in the form of closely held corporations, partnerships, or sole proprietorships should be supported by detailed financial statements on these entities. Net equity positions should be reviewed to determine the reasonableness of the carrying value and the potential impact of related debt. In addition, if an individual's financial standing is largely dependent upon appreciated value of real estate or closely held companies, the basis for valuation of the assets should be sought.

For state nonmember charters, background checks are normally requested by the Regional Office and if necessary and available, forwarded to field personnel for review during preparation of the investigation report. Such information provides an independent, third party check that can be used to verify the applicant's stated financial position, credit history, and confirm the absence of public filings and judgements. Liens, lawsuits, wage assignments, defaults, and public filings such as bankruptcies and judgements will be shown. The major credit reporting agencies also provide an additional service that automatically alerts the requester to possible false social security numbers and high risk addresses such as post office boxes, and multiple business addresses.

If necessary, additional information can be requested through the Regional Office, including Nexis/Lexis. These systems feature searches that can be conducted by key words or names. Nexis provides access to numerous news service publications and Lexis allows for a search of legal databases containing final case law from Federal and State courts. Finalized civil and criminal proceedings as well as bankruptcy cases are listed. Also, a background check can include a search of State Corporation Commission records, Dun & Bradstreet, and county and other State records. The Federal Reserve also maintains information on international and foreign companies.

Be cautious of bank ownership that is restricted to a single individual or entity, or a small group of individuals who lack broad-based financial strength. Also identify any proposed directors that have little or no prior financial institution experience, minimal financial interest in the proposal, or are poorly equipped to contribute to policy formation or adequate supervision. Determine whether senior officers lack necessary experience, or have not served in senior management positions, which provide adequate insight into proposed roles. The SOP requires at least a five-member board of directors. At a minimum, an even mix of directors with and without banking experience is preferred. The proposed board should provide for officer/director continuing education, and a management succession plan.

The SOP requires that the proposed full-time chief executive officer be made known to the FDIC. If the proposed CEO has not served in a similar capacity, it is important to determine whether the individual has the technical competence to fulfill the responsibilities of the position. Further, the proposed CEO's expertise and experience should correlate with the proposed business plan. Knowledge of such areas as lending and investments, interest rate risk management, internal controls, and bank regulations should be considered.

The proposed operating policies and strategic plan should be reviewed in assessing management. Inadequate policies may be an indication of a weak management team. Written investment, loan, funds management, and liquidity policies should be reviewed and comments should be made regarding their soundness and acceptability. The CEO is also expected to be a qualified and experienced lending officer. If not, an explanation should be provided and the name of the proposed chief lending officer should be furnished.

While conditional approval can be granted prior to the selection of a chief executive officer or primary lender, this is allowable in only very limited circumstances. An example is where the new bank will be owned by an "eligible holding company" as defined in section 303.22 of the FDIC's regulations. Ultimately, prior to opening, these individuals should be identified and their abilities assessed. Any changes in the directorate, active management, or 10% shareholders prior to the bank's opening must also be disclosed to the FDIC in writing.

When it appears that an unfavorable ruling will be made regarding an individual's qualifications or fitness to serve, the examiner should consult with the responsible Case Manager. The examiner should thoroughly support any negative assessment by:

- Conducting an adequate investigation into the individual's qualifications;
- With the concurrence of the Case Manager, give the individual the chance in an interview or letter to respond to any objections raised;
- Checking any files to which the FDIC has access before making an adverse determination regarding the individual;
- To the extent possible, attempting to locate documentary evidence rather than relying on oral opinions.

All information relied upon should be maintained. When information is obtained from an outside source, every effort should be made to obtain such information in writing and verify through a secondary source.

Organizational expenses should be reviewed for reasonableness. Prudent management would not commit a bank to excessive expenses, the existence of which may be indicative of a management deficiency, even if the fees or costs were approved by formal action of the incorporating shareholders. This applies to all costs, organizational expenses, and legal fees. Identify and assess the source of funding; start-up cash, personal or bank loans.

Review expenses for professional or other services rendered by insiders for any indication of self-dealing to the detriment of the institution or its shareholders. The FDIC expects full disclosure to all directors and shareholders of any arrangement with an insider.

Employment agreements should be reviewed to ensure that the contracts limit severance pay to a duration of one year. Under Part 359 - Golden Parachutes, severance payments are limited to one year in the case of troubled institutions. While not applicable to non-troubled institutions, the one-year guideline should be used as a benchmark. Section 359.1(f)(2)(v) states payments pursuant to a nondiscriminatory severance plan should not exceed the base compensation during the twelve months immediately preceding termination. Employment contracts that contain severance payments exceeding one year of compensation should be assessed for appropriateness and supported by extraordinary factors.

## **Stock Options and Warrants**

Organizers/incorporators (incorporators) may propose establishing stock benefit plans, including stock options, stock warrants, and similar stock based compensation plans. Participants may include officers as well as directors, although the FDIC anticipates that such plans will focus primarily on active officers. Stock benefit plans may also be established to compensate incorporators who place funds at risk to finance the organization or who provide professional or other services during the organizational phase. Stock option/warrant plans are also found in both private and public stock offering material.

Management stability is generally an essential element for the ultimate success of a de novo institution. Therefore, the structure of the stock benefit plans, whether available to active management or incorporators, should encourage the continued involvement of the participants and serve as an incentive for the successful operation of the institution. Satisfactory management should not commit the bank, directly or indirectly, to plans that result in excessive compensation to insiders, place undue incentives on short-term performance (at the potential expense of long-term safety and soundness), or present other unfavorable features.

The SOP describes features that are required in order for stock benefit plans to be deemed acceptable, and sets forth certain unacceptable features. In considering whether stock benefit plans are acceptable, each case should be reviewed independently. Stock benefit plans involving only a nominal percentage of ownership in the proposed institution need not be subjected to in-depth scrutiny.

Guidance provided in the SOP distinguishes between two types of award plans:

1. Options/warrants granted to directors and active management to reward future performance. (Type 1)
2. Options/warrants granted to incorporators as compensation for financial risk borne during the organizational phases or as compensation for professional or other services rendered in conjunction with the organization. (Type 2)

Type 1 plans for active directors and officers must include the following provisions and should be reviewed as part of the total compensation package:

- disclosure,
- duration limits (maximum 10 years),
- vesting requirements (generally, a minimum of three years, in equal amounts),
- transferability restrictions (not transferable),
- exercise price requirements (not less than fair market value at time of grant),
- rights upon termination (expire within a reasonable time), and
- an "exercise or forfeiture" clause (in the event capital falls below regulatory minimums).

Examiners should refer to FASB Statement No. 123, "Accounting for Stock-based Compensation", which provides guidance on calculating fair market value of stock options.

Type 2 plans do not require vesting, transferability restrictions, or continued association with the institution, but would require equal restrictions regarding disclosure, duration limits, strike price requirements, and an "exercise or forfeiture" clause.

Type 2 plans for incorporators not continuing as directors or officers should serve as compensation for services rendered or "seed" money placed at risk. Typically, it is the latter since professional services (accounting, legal, etc.) are normally paid for in cash. Incorporators often receive a proportional amount of stock after the bank is established as "repayment" of their initial financial contribution. In addition to stock acquired in this manner, incorporators may also receive some proportional volume of stock options/warrants as compensation for financial risk borne during the organizational phase of the bank.

The following summarizes the plan types:

## Type 1 Plans

- **Directors and officers who are not incorporators** may participate in prospective management incentive plans. Such plans should be reviewed as part of the total compensation package offered to the individuals involved.
- **Incorporators who are also directors and officers** are allowed to receive a maximum of one option/warrant for each share of stock for which they subscribed in the initial offering. An incorporator who will also be a senior executive officer may receive additional options as part of a prospective management incentive plan. The volume of additional options/warrants proposed beyond that based on stock subscribed should be reviewed for reasonableness on a case-by-case basis, giving consideration to the individual's financial commitment, time, expertise, and continuing involvement in the management of the proposed institution.

## Type 2 Plans

- **Incorporators who are not continuing as directors or officers** are allowed to receive a maximum of one option/warrant per share received for "repayment" of seed money and do not qualify for options/warrants based on additional stock subscribed beyond that which is a return of seed money.
- **Incorporators who are not continuing as directors or officers** who agree to accept shares of bank stock as payment for professional services (which otherwise would have been purchased from non-insiders) are also

allowed to receive a maximum of one option/warrant for each share received as payment for professional services. The value of such professional services should be supported by proper documentation.

**RED FLAGS.** Stock appreciation rights, phantom stock, and other similar plans that include a cash payment to the recipient based directly on the market value of the depository institution's stock are unacceptable. These plans have the potential of removing an undetermined amount of cash from the bank's capital accounts, in contrast to option plans that provide an infusion. Under a cash-less exercise of options plan, a broker lends funds to exercise the options and immediately sells the shares to repay the loan. This discourages insiders from retaining the stock and having an on-going stake in the bank. Further, the bank should not be assuming responsibility for paying any of the taxes associated with exercise of the options. These types of options are objectionable in the formative years of a new bank when there is often a need to preserve capital during a period of rapid growth and operating losses.

If the proposal involves the formation of a de novo holding company and a stock benefit plan is being proposed at the holding company level, that plan will be reviewed by the FDIC in the same manner as a plan involving stock issued by the proposed institution. Many de novo banks are organized as subsidiaries of a bank holding company whose only substantive function is to own the stock of the proposed bank. If the FDIC did not assert its right to set standards on stock benefit plans sponsored by de novo shell holding companies organized to sponsor new banks, the FDIC would in essence be giving up its ability to review stock benefit plans in new banks since the agency's requirements could easily be avoided by organizing a bank holding company.

The FDIC does not assert the right to regulate stock benefit plans for *operating* holding companies or holding companies with other material businesses. Additionally, the above criteria relating to stock benefit plans should not be applied to operating institutions but rather only to de novo institutions.

Finally, the following documents provide good guidance and resource on the subject of stock options; Q/A on Stock Benefit Plans <http://fdic01/division/DSC/rmas/OptionsQA.doc> Fairmark Press Tax Guide for Investors <http://www.fairmark.com/execcomp> the Foundation for Enterprise Development <http://www.fed.org> and the National Center for Employee Ownership <http://www.nceo.org>.

Fidelity bond coverage and excess employee dishonesty bond coverage should equal or exceed \$1 million if the primary blanket bond is less. It is helpful if a binder or commitment letter is obtained; however, approval may be conditioned upon acquisition of adequate coverage prior to opening.

Applicants are expected to commit to obtain an opinion audit by an independent public accountant annually for at least the first three years. The requirement for an external audit is a standard condition of the FDI Order granting deposit insurance. When the applicant is owned by a holding company, a consolidated audit of the holding company will generally suffice.

The proposed management structure should be reviewed to ensure that no management interlocks exist as defined in Part 348 of the FDIC Rules and Regulations.

Conclude with a "Favorable", Unfavorable" or "Favorable Subjected to Conditions" statement.

## **RISK TO THE FUNDS**

Assess the proposed institution's business plan, particularly addressing any unsound activities, practices or other issues. Any high-risk activity to establish market share, attain growth, or provide for profitable operations should be discussed. Business plans that are not commensurate with management's capabilities, should be addressed here as well. Operating plans that rely on high risk lending, niche marketing or significant funding from sources other than core deposits or that diverge from conventional banking will require substantial documentation as to the suitability of the proposed activities. Extensive documentation will also be necessary when economic conditions are marginal. The business plan should demonstrate a reasonable ability to achieve sustainable market share, generate earnings, and attract and maintain adequate capital.

**Industrial Loan Companies (ILC) and Special Purpose Banks (SPB)**

Industrial loan companies and special purpose banks are unique in that neither are considered “banks” under the Bank Holding Company Act. As such, parent and affiliated entities are not regulated by Federal or State supervisory agencies.

Currently, states offering the ILC charter include California, Colorado, and Utah. The charters typically allow institutions to be organized and owned by commercial enterprises, including retailers and manufacturers. Special purpose banks can include credit card issuers organized under the Competitive Equality in Banking Act (CEBA) and trust companies. Because these charters allow institutions to export rates and terms, the formats can provide for a single platform from which to operate in all 50 states. The charters also provide access to the payment system and additional sources of funding.

However, the ILC charter also presents a potentially significant limiting factor that emanates from the stated intention of serving the working class within an institution’s defined market area. To encourage ILC’s to maintain this focus, institutions are prohibited from accepting demand deposits if total assets exceed \$100 million, generally. Although not restricted by regulation, in practice, special purpose institutions might limit their deposit activities.

In general, ILC’s and special purpose banks limit their deposit activities to money center operations or brokered deposits; retail accounts might be limited to time deposits and accounts securing outstanding credit lines. In certain operations, including credit card and trust operations, deposit activities might be limited to a single account from the parent organization – a \$500,000 deposit that, under the FDIC’s General Counsel’s Opinion, qualifies as “being in the business of accepting deposits.”

Regardless of the form of charter, ILC’s and special purpose charters present unique characteristics that must be fully considered during the investigation. As noted, these include the absence of a regulatory regime outside the insured entity and unique limitations or practical restraints on deposit activities. When coupled with the broad powers conferred, examiners must be particularly cautious in reviewing management competencies, corporate structures and relationships, and the underlying business plans.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

**CONVENIENCE AND NEEDS OF THE COMMUNITY TO BE SERVED**

Discussion of this factor should begin with a description of the primary trade area, including its location and population. A drive through the neighborhood surrounding the proposed location may be beneficial in determining the visibility, proximity to potential customers, accessibility, and immediate competition. A general discussion of land development in the immediate trade area may also be pertinent. Any differences between the examiner’s perception of the trade area and that of the proponents should be discussed.

Also provide a general discussion of the relevant economic conditions, primary industries, and employers. Economic data should be limited to relevant information and relate a general understanding of the vitality and composition of the local economy. Population figures are particularly relevant (especially growth rates) and data establishing trends and projections should be provided if available. Several sources of economic data that provide insight into the economic conditions of the State, county or MSA are available. These include the Federal Reserve Quarterly Economic Review, the FDIC’s statistical publications and databases, and other economic periodicals published by credible sources.

Detail competition, both bank and non-bank, if applicable. Usually this is provided by the organizers, but driving through the surrounding area or consulting data that provides a summary of branches can be beneficial.

Finally, consider the services to be offered by the applicant and how they differ from those presently available including physical convenience. Consult with the responsible Case Manager to determine CRA requirements.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

## **CONSISTENCY OF CORPORATE POWERS**

This factor was originally intended to eliminate institutions with broad-based charters that permitted the applicant to engage in unusual or risky forms of business. However, most states have issued statutes that preclude granting any powers inconsistent with the FDI Act. If any doubts exist, the Legal Division should be contacted. Pursuant to Section 24 of the FDI Act, no insured bank may engage in any activity that is not permissible for a national bank unless the FDIC has determined that the activity would not pose a significant risk to the fund and the institution is in compliance with applicable capital regulations. Applicants are also prohibited from exercising trust powers without the written approval of the FDIC; most States also require written approval.

Conclude with a “Favorable”, Unfavorable” or “Favorable Subjected to Conditions” statement.

## **OTHER MATTERS**

Currently, it is the responsibility of the examiner to evaluate the applicant's Articles of Incorporation and Corporate Bylaws. Of particular importance is a review of the director indemnification, to ensure that the agreements are not overly liberal. Liberal clauses, which include protection against gross negligence and fraud, should be closely scrutinized. The FDIC has taken the position that such broad agreements are not acceptable. With case manager concurrence, consult with a Regional Office attorney.

Review the offering circular when securities are to be offered to the public. The goal is to ensure that de novo financial institutions comply with the anti-fraud provisions of the Federal securities laws that require full and adequate disclosure. Flawed disclosures may expose the institution to litigation and serious capital loss. Refer to the FDIC Statement of Policy Regarding Use of Offering Circulars in Connection with Public Distribution of Bank Securities. The Washington Office's Registration, Disclosure and Securities Operations Unit normally reviews both private and public offering materials and is available for assistance.

The review should insure that the circular provides sufficient disclosure of all material facts. SEC Rule I Ob-5 makes it unlawful to employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact or to omit a material fact in connection with an offering of any security.

In most cases, when securities are offered to the public an attorney specializing in securities law is employed. This usually ensures that the basic disclosures are made.

Offering circulars may also disclose proposed stock option plans, employment agreements, and issuance of stock warrants that should be closely reviewed.

Officials of area depository institutions should be contacted during the investigation and given an opportunity to express their opinions regarding the application. Opinions of other business and community leaders may also prove beneficial. Any formal objections should be investigated and appropriate comments set forth in the report. Sole reliance upon the opinions of competitors should be avoided and impartial conclusions should be reached. A sample Community/Competition Interview form is found in Appendix A.

For applicant's proposing to deliver services over electronic channels, such as the Internet or wireless devices, the examiner should assess the information systems infrastructure, policies and security. An information systems subject matter expert should be required to participate in the investigation, depending on the complexity of the proposed delivery channel.

## INVESTIGATION REPORT SUMMARY

Detail the applicant's designated contact person, including title, mailing address, email address, fax and phone number.



**APPENDIX A**

**PROPONENTS/ORGANIZERS MEETING AGENDA SAMPLE**

**AND**

**MANAGEMENT/DIRECTOR INTERVIEW FORM**

**AND**

**COMMUNITY/COMPETITION INTERVIEW FORM**

ANYWHERE BANK (PROPOSED)  
MEETING WITH PROPONENTS  
MAY 15, 2002

## AGENDA

### I. Opening Remarks

- A. Acquaint Directors With Their Responsibilities and Liabilities
- B. Apprise Organizers of Regulatory Involvement and Concerns

### II. Directors Responsibilities

- A. Sound, Independent Business Judgment
  - a. Candid, Open Discussion of Bank Business
  - b. Documentation of Decisions and Expression of Dissent Within the Board Minutes
  - c. Confidentiality and Integrity
- B. Informed of All Facets of Bank, Operations, Regulatory Environment, Competitive Environment
  - a. Management, Reports, UBPRs
  - b. Report of Examination and Visitation
  - c. Internal and External Audit Reports
  - d. Trade Publications, Seminars, Meetings
- C. Direct the Bank in a Prudent Manner
  - a. Establish goals, policies and strategies
  - b. Hire Suitable Management to Implement Goals
  - c. Monitor Management's Compliance with Board Directives
  - d. Discipline or Dismiss Management as Necessary
- D. Build Business for the Bank
- E. Ethical Conduct and Policy
  - a. Regulation O
  - b. Represent the Bank in Your Community

### III. Director Liability

- A. Can be Personally Liable for Losses Arising From
  - a. Legal lending Limit Violations
  - b. Insider Transactions
  - c. Bank Failures
- B. Civil Money Penalties
- C. Civil Suites (Shareholders) for Breaches of

- a. Duty of Care
- b. Duty of Knowledge
  - aa. Willful Ignorance is not a Defense Against Liability for Negligence
- D. Board Minutes are Legal Record and Vehicle for Expressing Dissent

## IV. Ongoing Regulatory Involvement

- A. Pre-opening Visitation
- B. New bank Visitation
- C. Examinations
  - a. Safety and Soundness
  - b. IS/Other Specialty
  - c. Compliance

## V. Why Banks Fail

- A. Bad Loans – Poor underwriting, selection of risk, etc..
- B. Poor Funds Management
- C. Pursuit of Earnings with High-Risk Lending and Investment
- D. Bad Management; Lack of Board Supervision

**MANAGEMENT/DIRECTOR INTERVIEW FORM**

Proposed Bank: \_\_\_\_\_

Location: \_\_\_\_\_

Director/Officer's Name: \_\_\_\_\_ Born: \_\_\_\_\_

Resident Of: \_\_\_\_\_ Years: \_\_\_\_\_

Principal Business: \_\_\_\_\_

# of Shares Subscribed: \_\_\_\_\_ % of Subscription financed: \_\_\_\_\_

Stock Payment Method: \_\_\_\_\_

Reasons for becoming a Director/Officer?: \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

How associated with proposal?: \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Previous experience as financial institution Director/Officer (If yes, when and where): \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Why does community need this Bank?: \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

What strengths/contributions will you bring to Board/Bank?: \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

How long have you known other Director/Officers?: \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

## Section 18.1

Impressions of other proponents as individuals and as a working team?: \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Is any one proponent Dominant? Passive? : \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

How much loan/deposit business will you bring to the bank in the first year?: \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Ever been denied credit for reasons of credit problems?: \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Ever been indicted/convicted of a felony?: \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

[illegible]

**COMMUNITY/COMPETITION INTERVIEW QUESTIONNAIRE**

Date: \_\_\_\_\_

Interviewee Name: \_\_\_\_\_

Location: \_\_\_\_\_

Need for an additional bank?: \_\_\_\_\_

---

---

---

Economy and outlook of the market/trade area?: \_\_\_\_\_

---

---

---

Deposit growth in the market/trade area and at your institution?: \_\_\_\_\_

---

---

---

Experience with or knowledge of  
organizers/CEO?: \_\_\_\_\_

---

---

---

---

---

Percentage of the market the new bank can expect to achieve?: \_\_\_\_\_

---

---

---

Loan rates at your institution? (Ask for a loan rate schedule in order to compare): \_\_\_\_\_

---

---

Deposit rates? (Ask for a deposit rate schedule): \_\_\_\_\_

---

---

Any official protest or objection to the proposal?: \_\_\_\_\_

---

---