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INTRODUCTION

Financial institutions operate within a regulatory framework based on state and federal statutes, regulations, and administrative rulings. These laws and regulations are designed to protect the public (depositors, consumers, investors, creditors, etc.) by establishing operational standards and consumer protections for the banking industry. Violations of laws and regulations can reflect negatively on a bank's board of directors and management and can expose an institution to financial and other risks. Accordingly, examiners must have a thorough knowledge of state and federal laws and regulations to ensure that violations are promptly detected and corrected.

Causes

Violations often result from management's unfamiliarity with, or misinterpretation of, governing statutes or regulations. Negligence and willful noncompliance may also lead to violations. To reduce the risk of violations, the board of directors and senior management should develop:

- Policies, procedures, and training programs designed to ensure that directors, officers, and employees are familiar with applicable laws and regulations;
- Monitoring procedures to assure compliance with laws and regulations in daily operations; and
- Procedures for detecting noncompliance, reporting it to the board and management, and correcting identified issues promptly.

Differences of opinion can arise regarding the interpretation of laws and regulations. If management disagrees with the applicability or meaning of a statute or regulation and examiners are in doubt as to its applicability or meaning, the examiners may consult with the regional office to confirm the applicability or meaning.

Willful acts of noncompliance with laws or regulations should be taken seriously and thoroughly investigated by examiners. Depending on the gravity of an offense and other factors, willful noncompliance may result in civil money penalties (CMPs), or other administrative actions under Section 8 of the Federal Deposit Insurance Act (FDI Act).

Significance

The fair and non-discriminatory treatment of stakeholders and customers should be sufficient reason for bankers to operate in accordance with laws and regulations. Bank directors and officers should be aware, however, that there are also more direct and personal reasons to conform to laws and regulations. Federal statutes and regulations (and those of some states) provide for the assessment of civil

money penalties against banks and individuals for certain violations. Additionally, most state laws provide that directors can be held personally liable for a bank's losses relating to illegal loans or other nonconforming assets (assets acquired or held by the bank in violation of a law or regulation). Such losses may also prompt requests for restitution or other corrective measures. Finally, infractions of laws and regulations may prompt litigation and requests for money damages by adversely affected parties.

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SCHEDULING VIOLATIONS

Examiners should cite apparent violations on the Violations of Laws and Regulations schedule of the Report of Examination (ROE). Nonconformance with interagency guidelines that are incorporated into regulations (such as Appendix A or B of Part 364, or Appendix A of Part 365 of the FDIC Rules and Regulations) should be segregated under an appropriate subheading, listed after cited apparent violations, and include information similar to apparent violations. Detailing infractions on one schedule allows examiners to present issues to bank officials more effectively and allows readers to evaluate the type and severity of apparent violations more easily. Comments should include:

- Clear, concise headings for each violation or group of related violations;
- Descriptions of each applicable statute or regulation;
- Details of the action or inaction that caused an apparent violation;
- Names and dates of directors' approvals/dissents;
- Management's response; and
- Commitment/timing of any promised corrective action.

When describing a law or regulation in the ROE, examiners should cite the specific section number and either quote or paraphrase the law or regulation. In controversial situations, examiners should generally quote applicable sections. In non-controversial situations, examiners may paraphrase regulations, but must ensure descriptions accurately convey a statute or regulation's main point. For example, "Section 337.3(b) prohibits banks from making large loans to directors without prior board approval."

Examiners must be accurate when describing the action or inaction that caused an apparent violation; however, it is generally unnecessary to provide lengthy explanations. For example, an infraction of Section 337.3(b) could be described as, "The \$3 million loan to Director Smith funded on 12/2/18 is in apparent violation of Part 337 because it was extended without prior board approval."

Examiners may avoid lengthy descriptions of violations relating to classified assets by referencing write-ups included in other ROE schedules, such as the Items Subject to Adverse Classification.

To reflect director responsibility and possible liability, report comments must identify the directors who approved or ratified the apparently unlawful actions, the date of the approvals, and the names of any dissenting directors. Examiners should follow these procedures even if an approval consisted merely of the ratification of a group of loans, possibly identified only by numbers.

General Considerations

- Use the phrase *apparent violation* to describe infractions directly related to laws and regulations, no matter how certain the violation may appear.
- List violations in order of importance, considering the substance and severity of the violation.
- Exercise care when citing apparent violations because incorrectly cited infractions discredit the ROE.
- State if an apparent violation was corrected during the examination.
- Generally, include sample lists when violations involve numerous accounts or credits. (Detail the total number of accounts or credits in the ROE, give complete lists to management, and retain a copy of the list in the workpapers.)
- Cite the specific section or subsection of a regulation, such as Section 337.3 or Section 337.3(b), when referring to specific regulations.
- Cite a regulation's part number, such as Part 337, when referring to general regulations.

The considerations above apply similarly to citations of nonconformance with guidelines incorporated into an appendix to a regulation. Key differences being:

- Use the term *nonconformance* to describe significant deficiencies in adherence to the guidelines contained in appendices to regulations, such as the appendices to Part 364 or 365.
- List nonconformance with such guidelines after apparent violation citations and under the separate heading *Nonconformance with Guidelines Incorporated into Appendices to Regulations*.

Uncorrectable Violations

Examiners should not continue to cite previously cited violations that cannot be corrected. For example, violations of the prior approval requirements of Regulation O are not correctable and should not be cited at subsequent examinations. However, examiners should cite repeat violations (new infractions of previously cited violations),

and continuing violations (violations that could have been, but were not, corrected).

Report Comments

If apparent violations of law or regulation, or nonconformance with an appendix to a regulation, are cited in the ROE, the Examination Conclusions and Comments (ECC) page must include, at a minimum, a brief summary comment and reference to the Violations of Laws and Regulations page. References to other report pages may also be necessary if related issues, such as internal control or policy weaknesses, are detailed elsewhere in the ROE.

Examiners should not refer to the FDIC's authority to impose CMPs, or to the possible amount of CMPs that may be imposed, except in serious situations. Examiners can comment that violations may be subject to CMPs if violations cited at previous examinations are repeated or not corrected.

Note: When an examiner concludes that violations detected during the examination warrant a CMP recommendation to the regional office, the home mailing addresses of all directors and any other individuals involved in the violation should be included in the Directors/Trustees and Officers section of the ROE.

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TYPES OF VIOLATIONS

The following sections describe common violations detected in safety and soundness examinations. Most examples relate to nonconforming assets.

Legal Lending Limit Violations

A borrower's debt at a bank may consist of several notes of different dates. When the total of such notes exceeds state or federal lending limits, courts have generally held that only the note(s) that created the excess above the lending limit constitutes an illegal extension. Until the note(s) are paid in full, they represent a violation for which the approving directors may be held liable. Generally, examiners should cite only the note(s) that caused the apparent violation. However, if state law or practice differs from this guidance, state law prevails.

Courts have also held that if several notes constitute a single transaction, all notes should be treated as a unit and the entire loan balance considered an illegal extension for which the approving directors may be held liable.

Note: Loans are sometimes made in conformance with statutory lending limits, but subsequently exceed lending limits due to a decline in capital levels or appraised values. Examiners should not cite violations in these situations unless indicated by state law. However, violations should be cited if the loans were renewed at levels exceeding lending limits.

Nonconforming Loans to Insiders

Bank directors and officers have responsibilities to stockholders and depositors. Their actions must be conducted in good faith and free from self-dealing or conflicts of interest. Loans to directors, officers, employees, principal shareholders, and their interests must be beyond reproach, and illegal loans must be reported and corrected as soon as possible.

Nonconforming extensions of credit to insiders and their interests may violate state laws, Federal Reserve Board Regulation O, or Section 337.3 of the FDIC Rules and Regulations. These statutes limit the dollar amount of loans banks may extend to insiders, prohibit banks from making insider loans on preferential terms or conditions, and establish recordkeeping requirements.

Nonconforming Affiliate Transactions

Sections 23A and 23B of the Federal Reserve Act govern transactions between member banks and their affiliates. Section 18(j) of the FDI Act makes Sections 23A and 23B applicable to state nonmember banks.

All infractions of Sections 23A and 23B, including nonconforming extensions of credit to, and illegal investments in, an affiliate should be cited as apparent violations.

Nonconforming Real Estate Loans

Various laws and regulations govern the extension of loans to purchase, or secured by, real estate. For example, Part 365 of the FDIC Rules and Regulations requires institutions to develop written policies that establish appropriate limits and standards for real estate related loans. Part 323 requires institutions to obtain appraisals from qualified appraisers for various real estate related financial transactions.

Generally, examiners should list the current book value of nonconforming loans if they identify violations of these or other real estate related regulations. In cases where violations involve multiple loans, only the loan(s) that created the violation should be cited.

Nonconforming Securities Securing Loans

Various statutes and regulations govern the process of collateralizing loans with securities. For example, Federal Reserve Board Regulation U restricts loans made for buying margin stock if the loans are collateralized by margin stock. Section 23A of the Federal Reserve Act prohibits banks, with certain exemptions, from securing loans to an affiliate using any affiliate's stock as collateral. Also, Treasury Department regulations prohibit the pledging of certain savings bonds as loan collateral. Where ineligible bonds are designated as collateral, examiners should not recognize the loan as secured. However, the loan itself may not be a violation and should not be included in this schedule unless collateral is required, or it is otherwise nonconforming. For example, it lacks a financial statement required by a state law for unsecured loans.

Loans collateralized in apparent violation of law or regulation should be cited at the current balance of the loans.

Securities Unlawfully Acquired or Held

Part 362 of the FDIC Rules and Regulations and many state laws restrict banks from investing in certain types of securities. For example, banks may be prohibited from acquiring common stock or other forms of equity investments. Exceptions are sometimes allowed for investments in subsidiaries holding title to bank premises, stock in bank service corporations, or securities taken in consideration of debt previously contracted (DPC). If a bank appears to have unlawfully acquired or held a security, examiners should contact the regional office and when appropriate cite the current book value as an apparent violation in the ROE.

Nonconforming Other Real Estate

State laws sometimes require banks to divest of, within defined periods, real estate acquired through foreclosure, repossession, or otherwise in satisfaction of DPC. Examiners do not need to cite violations for real estate acquired DPC and held longer than permitted by statute if the asset is carried on the books at a nominal value. However, real estate acquired illegally (as distinguished from real estate acquired DPC), should be cited as an apparent violation even if fully charged off.

Charged-Off Nonconforming Assets

Illegally held or acquired assets are violations regardless of any related charge-offs. For example, if a bank makes a loan that exceeds legal lending limits and subsequently

charges off all or part of the debt, the borrower remains liable for the unpaid loan balance and the loan remains a violation at the original amount. Were this interpretation not in place, bank management, desiring to accommodate a borrower beyond the legal limit, could make excessive loans and simply charge them down to the legal limit or eliminate them from their financial records. The same general rule holds true regarding most other types of nonconforming assets.

All Other Violations

Some violations of laws and regulations are not associated with the acquisition or holding of a nonconforming asset. They include most apparent violations of the FDI Act, FDIC Rules and Regulations, Bank Holding Company Act, and other similar federal and state laws and regulations.

However, some of these apparent violations are not scheduled in the safety and soundness ROE. For example, apparent infractions of the federal criminal code are reported separately, and infractions of the Truth in Lending Act and Equal Credit Opportunity Act are excluded since they are covered in separate consumer compliance ROEs.

Nonconformance with Guidelines Incorporated into Regulations

Nonconformance with guidelines or standards that are incorporated into regulations (such as Appendix A or B of Part 364, or Appendix A of Part 365 of the FDIC Rules and Regulations) should be scheduled in the Violations of Laws and Regulations page, under a separate heading and after apparent violations of laws and regulations. Related supervisory recommendations should be summarized on the ECC page and should include at a minimum, a brief summary comment, and reference to the Violations of Laws and Regulations page, and other pages when applicable. When appropriate, the concerns should be brought forward to the Matters Requiring Board Attention schedule.

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EVALUATION OF MANAGEMENT

Examiners must consider a bank's adherence to laws, regulations, and internal policies when assigning Management and composite ratings. Compliance with statutory and regulatory provisions is more likely achieved when the board of directors and senior management recognize the importance of legally conforming behavior and maintain appropriate internal guidance. The board should establish policies, procedures, and controls designed to ensure compliance with legal and regulatory directives, prompt detection of noncompliance, timely

implementation of corrective measures, and adequate training of officers and employees to prevent infractions. Deficiencies in these areas reflect negatively on management and should be appropriately recognized.

For example, regular or willful noncompliance reflects more negatively on management than a minor infraction of a technically complex statute, and examiners should tailor comments and recommendations to match the severity of all infractions of laws and regulations. However, regardless of their perceived importance, it is important that management promptly correct all apparent violations.

References:

- Manual Section 16.1, ROE Instructions
- Manual Section 4.1, Management
- Manual Section 4.3, Related Organizations