As published in ABA Risk and Compliance – March/April 2026

CrossCheckCompliance

Regulatory Compliance

Insider Lending Under Regulation O: What's allowed, what's prohibited, and why

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LOANS TO INSIDERS present unique risks for financial institutions, particularly when those loans are not subject to the same scrutiny applied to other extensions of credit. Regulation O establishes the framework for managing those risks. Regulation O exists to prevent bank insiders from using their positions to obtain preferential access to credit — a risk that can undermine fairness, safety, and soundness if left unchecked. Enacted in response to concerns raised by the Financial Institutions Regulatory and Interest Control Act of 1978, Regulation O establishes clear rules governing loans to executive officers, directors, and principal shareholders of member banks.

The Federal Reserve Board (FRB) was granted rule-making authority for Regulation O (Reg O or regulation) and maintains that authority currently. While the FRB has rule-making authority, banks and credit unions which are subject to other regulators (Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and National Credit Union Administration (NCUA)) are also subject to the requirements of the regulation. The regulation was enacted primarily to prevent insiders from using their positions to obtain loans on better terms than other customers. This article provides a refresher on the requirements of the regulation and finishes with suggestions for the compliance management program to help mitigate a financial institution's (FI's) Reg O risk.

Who counts as an insider? Understanding Regulation O's core definitions

Arguably the most important term in Reg O is "insider" and who falls under the classification of insider for purposes of compliance with the regulation. An insider to the FI is as an "executive officer, director, or principal shareholder, and

includes any related interest of such a person." What do each of those terms in the definition of insider mean, especially in relation to Reg O? Let us take each term one-by-one.

- An executive officer is a person who participates or has the authority to participate (other than in the capacity of a director) in major policymaking functions of the company or FI, whether: the officer has an official title; the title designates the officer an assistant; or the officer is serving without salary or other compensation. (§215.2(e)(1))
- A director is a member of the Board of Directors (Board), whether receiving compensation or not. If the director was not elected by shareholders, is not authorized to vote on matters before the Board, and provides solely general policy advice to the Board, they are considered an advisory director and not subject to Reg O. (§215.2(d)(1))
- A principal shareholder is a person (other than an insured bank) that directly or indirectly, acting through or in concert with one or more persons, owns, controls, or has the power to vote more than 10 percent of any class of voting securities of an FI or company. Shares owned or controlled by a member of an individual's immediate family are considered by the regulation to be held by the individual. (§215.2(m)(1))
- A related interest of a person means a company that is controlled by that person; or a political or campaign committee that is controlled by that person or the funds or services of which will benefit that person. (§215.2(n))
- Another key term is "affiliate" which is any company of which an FI is a subsidiary or any other subsidiary of that company (§215.2(a)).
- "Company" as used in the regulation means any corporation, partnership, trust (business or otherwise), association, joint venture, pool syndicate, sole proprietorship, unincorporated organization, or any other form of business entity. Excluded from the definition is an insured depository institution or a corporation majority owned by the federal or a state government. (§215.2(b))

Finally, Reg O defines an extension of credit as a making or renewal of any loan, a granting of a line of credit, or an extending of credit in any manner whatsoever, (§215.3(a)) and includes:

1. A purchase under a repurchase agreement of securities, other assets, or obligations;
2. An advance by means of an overdraft, cash item, or similar;
3. Issuance of a standby letter of credit (or other similar arrangement regardless of name or description) or an ineligible acceptance (these terms are defined in Regulation H (§208.24);
4. An acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which an insider may be liable as maker, drawer, endorser, guarantor, or surety;
5. An increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for:
6. Accrued interest; or
7. Taxes, insurance, or other expenses incidental to the existing indebtedness.

8. An advance of unearned salary or other unearned compensation for a period of more than 30 days; and
9. Any other similar transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.

In addition to defining what is an extension of credit, the regulation also establishes those transactions that are not included in the definition. Refer to Regulation O §215.3(b) for the extensive list.

What Regulation O requires: Core prohibitions and compliance obligations

With an understanding of several key terms, the Reg O requirements are divided into two distinct categories: General Prohibitions and Recordkeeping and Reporting.

General prohibitions

The general prohibitions in Reg O fall into four categories: terms and creditworthiness, prior approval, individual and aggregate lending limits (including exceptions to the lending limits), and overdrafts.

Internal controls for Regulation O do not have to be overly complex, but they must be scaled to the institution's size, complexity, and level of insider lending risk.

1. Terms and creditworthiness — this requirement is relatively straightforward. An FI may only extend credit to an insider if it is on substantially the same terms (including interest rates and collateral requirements) as those in place for comparable transactions with customers and employees not subject to the Reg O requirements. In addition, the FI must follow credit underwriting procedures that are not less stringent than those used for non-insiders.

Also, the transaction should not involve more than the normal risk of repayment or present other unfavorable features as compared to transactions involving customers not subject to the regulation. An exception to these requirements is when an FI has established an employee benefit that allows credit to be granted on better terms (lower interest rate than available to the public for example) and insiders are offered the same terms as all employees under the benefit. §215.4(a)

2. Prior approval — the definition is found in §215.4(b) of Reg O which states that an extension of credit by an FI to its insiders or the related interests of its insiders must be approved by the FI's Board before the credit is extended if the credit extended, together with all other credit extended by the FI to the insider and their related interests, exceeds $25,000 or 5 percent of the FI's unimpaired capital and surplus (this amount is defined in §215.2(i)), or in any event exceeds $500,000. The requirement for prior approval applies to revolving lines of credit, specifically the draws made against a line of credit. Unless the draw is made within 14 months of the origination date of the line of credit, if the limits noted above are exceeded, the Board must approve the draw before the funds may be extended to the insider. An insider may not participate directly or indirectly in the vote to approve an extension of credit when the insider or their related interest is party to the extension.

3. Individual and aggregate lending limits — The individual lending limit is the total amount of all loans made to an individual insider and to all related interests of that insider §215.4(c). It may not exceed 15% of the FI's unimpaired capital and surplus in the case of loans that are not fully secured, and 25% of the FI's unimpaired capital and surplus in the case of loans that are fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the loan.

The aggregate lending limit is the total amount of all extensions of credit to all insiders and their related interests §215.4(d) which may not exceed 100% of the FI's unimpaired capital and surplus. Smaller FIs, those with total deposits of $100 million or less, are given an exception to the aggregate lending limit. The Board at such an FI may make a resolution annually to increase the aggregate lending limit, up to two times the FI's unimpaired capital and surplus under certain conditions:

A. The Board determines that such higher limit is consistent with prudent, safe, and sound banking practices in light of the FI's experience in lending to its insiders and is necessary to attract or retain directors or to prevent restricting the availability of credit in small communities;
B. The resolution sets forth the facts and reasoning on which the Board bases the finding, including the amount of the FI's lending to its insiders as a percentage of the FI's unimpaired capital and unimpaired surplus as of the date of the resolution;
C. The FI meets or exceeds, on a fully phased in basis, all applicable capital requirements established by the appropriate federal banking agency; and
D. The FI received a satisfactory composite rating in its most recent Report of Examination.

Additional limits and restrictions on loans to executive officers and directors are set forth in §215.5, including

- §215.5(a) – No member bank may extend credit to any of its executive officers, and no executive officer of a member bank shall borrow from or otherwise become indebted to the bank, except in the amounts, for the purposes, and upon the conditions specified in paragraphs (c) and (d) of this section.
- §215.5(b) – No member bank may extend credit in an aggregate amount greater than the amount permitted in paragraph (c)(4) of this section to a partnership in which one or more of the bank's executive officers are partners and, either individually or together, hold a majority interest. For the purposes of paragraph (c)(4) of this section, the total amount of credit extended by a member bank to such partnership is considered to be extended to each executive officer of the member bank who is a member of the partnership.
- §215.5(c) – A member bank is authorized to extend credit to any executive officer of the bank:
  1. In any amount to finance the education of the executive officer's children;
  2. In any amount to finance or refinance the purchase, construction, maintenance, or improvement of a residence of the executive officer, provided:

   i. The extension of credit is secured by a first lien on the residence and the residence is owned (or expected to be owned after the extension of credit) by the executive officer; and
   ii. In the case of a refinancing, that only the amount thereof used to repay the original extension of credit, together with the closing costs of the refinancing, and any additional amount thereof used for any of the purposes enumerated in this paragraph (c)(2), are included within this category of credit;
3. In any amount, if the extension of credit is secured in a manner described in § 215.4(d)(3)(i)(A) through (d)(3)(i) (C) of Regulation O; and
4. For any other purpose not specified in paragraphs (c)(1) through (c)(3) of this section, if the aggregate amount of extensions of credit to that executive officer under this paragraph does not exceed at any one time the higher of 2.5 per cent of the bank's unimpaired capital and unimpaired surplus or $25,000, but in no event more than $100,000.

§215.5(d) — Any extension of credit by a member bank to any of its executive officers shall be:

1. Promptly reported to the member bank's board of directors;
2. In compliance with the requirements of § 215.4(a) of this part;
3. Preceded by the submission of a detailed current financial statement of the executive officer; and
4. Made subject to the condition in writing that the extension of credit will, at the option of the member bank, become due and payable at any time that the officer is indebted to any other bank or banks in an aggregate amount greater than the amount specified for a category of credit in paragraph (c) of this section.

There are exceptions to these lending limits which are laid out in §215.4(d)(3).

4. Overdrafts — As noted above, in addition to restrictions on loans to insiders, there are restrictions related to the payment of insider overdrafts. According to §215.4(e), an FI may not pay an overdraft of an executive officer or director of the FI or any of its affiliates unless the payment is made according to:

A. A written, preauthorized, interest-bearing extension of credit plan that specifies a method of repayment; or

B. A written, preauthorized transfer of funds from another account of the account holder at the FI.

C. This prohibition does not apply to payment of inadvertent overdrafts on an account in an aggregate amount of $1,000 or less, if:

D. The account is not overdrawn for more than five business days; and

E. The FI charges the executive officer or director the same fee charged to any other customer in similar circumstances.

Meeting Regulation O's recordkeeping and reporting requirements

Regulation O describes potential recordkeeping methods for use by FIs. While it stops short of requiring use of one of the two methods, it does state that any alternative recordkeeping method must be reviewed by the FI's federal banking agency which must indicate that the FI's recordkeeping method is at least as effective as the two methods identified by Regulation O. See §215.8 for details on the two recordkeeping methods.

Regulation O establishes several different reporting requirements. First, §215.10 states that FIs must include, with each report of condition, a report of all extensions of credit by the FI to its executive officers since the date of the last report of condition. §215.9 and §215.12 establish requirements for information that must be reported in writing to the Board. §215.11 requires an FI, upon written request from a member of the public, to provide the names of each of its executive officers and each of its principal shareholders or the related interests to whom the FI had, at the end of the previous quarter, an outstanding extension of credit that exceeded the lending limits of Regulation O.

By remaining knowledgeable about the requirements, establishing controls, and including Regulation O in your FI's compliance management system, compliance with the requirements will be low on your risk radar.

Failing to comply with the requirements and restrictions in Regulation O opens FI to compliance and other risks. Examination findings due to violations of Regulation O may require the board to act to improve risk management processes related to the identified risk associated with loans to insiders.

Therefore, FIs need to tailor their risk management processes to the level of risk and activity regarding loans to insiders. In other words, internal controls should be scaled for the size and complexity of the FI.

Building an effective Regulation O compliance program

Including Reg O in your FI's compliance management system is essential to mitigate the risk of noncompliance; however, the controls for the regulation do not have to be overly complex. For example:

- Develop a log that includes all insiders, any related interests of those insiders, any loans made to those insiders, and the total amount of all the loans made to insiders as one option to track credit extensions to insiders. The Chief Lending Officer or other responsible delegate should maintain the Reg O/insider log.
- The loan origination system should be programmed to flag insiders and loans requested by insiders so that those loans are captured and reviewed by management and the Board. This should include a mechanism to document the Board's approval as part of the loan file.
    - In lieu of a system flag, loan originators and processors should be provided with a current list of insiders and related interests. Procedures should be updated to require a review of the list and confirmation of whether the loan is for an insider.

- Implement a process for review of overdrafts incurred by insiders to mitigate the risk of violation.
- Implement a periodic review of the insider list to ensure it remains current and accurate.
- Include Reg O as part of the compliance risk assessment.
- Implement independent monitoring and audit of Reg O at a frequency commensurate with the level of risk established by the compliance risk assessment.
- Develop regular reporting to the Board to keep the Board informed about the aggregate amount of loans to insiders and the ratio of this amount to the FI's unimpaired capital and surplus.
- Develop training for employees involved in the lending process to ensure compliance with the regulation.
- Establish a procedure for responding to potential written requests from the public and maintaining a record of all requests received. §215.9

By remaining knowledgeable about the requirements, establishing controls, and including Regulation O in your FI's compliance management system, compliance with the requirements will be low on your risk radar. To aid in complying with the requirements of Regulation O, the Federal Reserve Board (FRB) has issued Frequently Asked Questions which are available on its website at www.federalreserve.gov/supervisionreg/legalinterpretations/reg-o-frequently-asked-questions.htm.

ABOUT THE AUTHOR

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