



# Supervision and Regulation Report

November 2019





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# Preface

To enhance public transparency and heighten accountability, the Board of Governors of the Federal Reserve System (Board) publishes periodic information about banking conditions and the Federal Reserve's supervisory and regulatory activities, typically in conjunction with testimony before Congress by the Vice Chair for Supervision.

The inaugural report, published in November of 2018, reviewed trends going back to the financial crisis. This report focuses on trends since the beginning of 2014.

The report consists of three main sections, in addition to a summary of key developments and trends:

- **Banking System Conditions** provides an overview of trends in the banking sector based on data collected by the Federal Reserve and other federal financial regulatory agencies, as well as market indicators of industry conditions.
- **Regulatory Developments** provides an overview of the current areas of focus of the Federal Reserve's regulatory policy work, including pending rules.
- **Supervisory Developments** provides background information on supervisory programs and approaches, as well as an overview of key supervisory themes and trends, findings, and priorities. The report distinguishes between large financial institutions and regional and community banking organizations, as supervisory approaches and priorities for these institutions frequently differ.



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# Summary

## *U.S. banking organizations remain strong.*

U.S. banking organizations continue to maintain strong capital and liquidity levels, while demonstrating healthy loan growth and improved profitability, allowing them to continue supporting households and businesses throughout the economic cycle.

Banks also continue to fix previously identified supervisory findings and improve their risk management. In particular, the number of outstanding supervisory findings has decreased for banks of all sizes. Current supervisory findings remain concentrated in nonfinancial areas, such as governance and risk management.

## *Supervisors continue to monitor evolving risks.*

Overall, U.S. banking organizations are better prepared now than before the last financial crisis to weather any potential downturn in the economic cycle. Recent stress test results show that capital levels of large firms remain above regulatory minimums even after a hypothetical severe recession. Using stress tests and other supervisory tools, the Federal Reserve continues to promote financial resiliency by monitoring the adequacy of the capital and liquidity positions of supervised institutions, as well as their lending standards, asset quality, profitability, and risk management practices.

## *The largest, most systemically important banking organizations are subject to the most stringent regulation and supervision.*

The Federal Reserve continues to ensure that the regulatory and supervisory environment is efficient, transparent, and simple and that expectations for individual institutions are appropriately tailored to risks for different banks. In particular, the most stringent regulatory and supervisory requirements are applied to the largest systemically important banking organizations. Firms with smaller risk profiles have less stringent requirements. Effectively tailoring supervisory expectations minimizes compliance burden without compromising an institution's safety and soundness.

## *The Board continues to promote the principles of efficiency, transparency, and simplicity in its approach to supervising and regulating institutions.*

**Efficiency** involves two components. The first relates to methods: efficient methods tailor the requirements and intensity of regulations and supervision programs based on the risk profile of firms. This minimizes compliance burdens while still achieving regulatory objectives. The second is related to goals: the Federal Reserve has a strong public interest in an efficient financial system, just as it does in a safe and sound one, and includes the efficient operation of the financial sector as one of the goals it seeks to promote through its regulation and supervision programs.

**Transparency** involves the presentation of regulations, guidance, and supervisory findings in a manner that is easy to understand. Transparency promotes accountability to the public and an effective regulatory process by exposing ideas to a variety of perspectives. Similarly, transparent supervisory principles and guidance allow firms and the public to understand the basis for a supervisory decision, thereby enhancing firms' ability to respond constructively to supervisors.

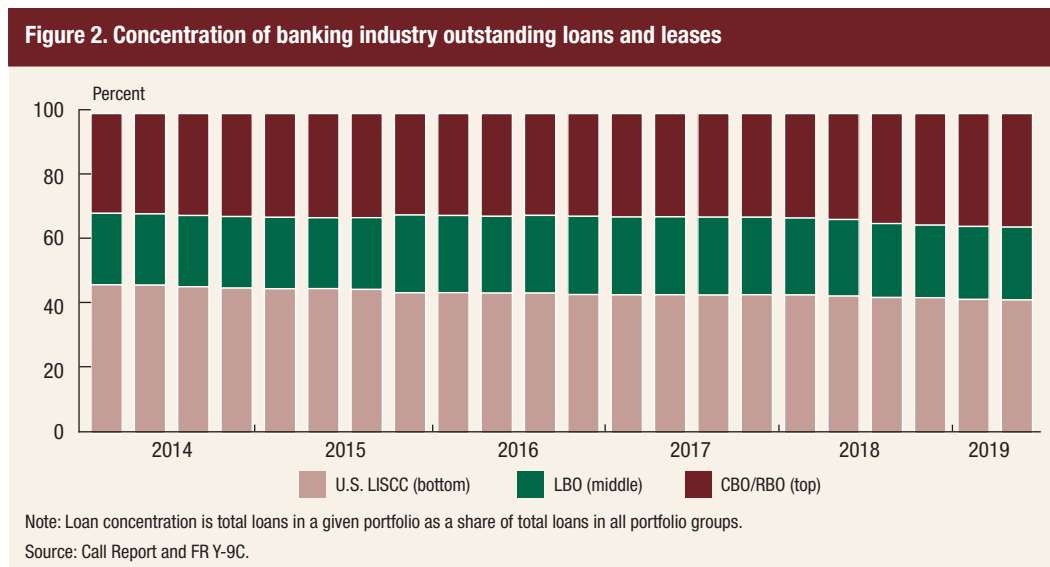
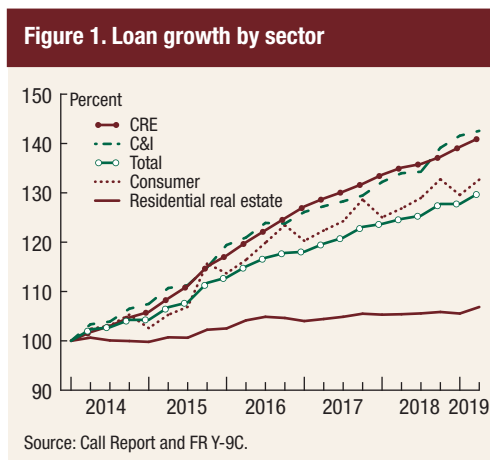
**Simplicity** involves developing the Federal Reserve's regulations and supervisory framework without unnecessary complexity and presenting expectations clearly and concisely. The objective of simplicity complements and supports the goal of transparency. Confusion and unnecessary compliance burden resulting from overly complex regulations inhibit progress toward a safe, sound, and efficient financial system.

# Banking System Conditions

## *Loan growth remains healthy.*

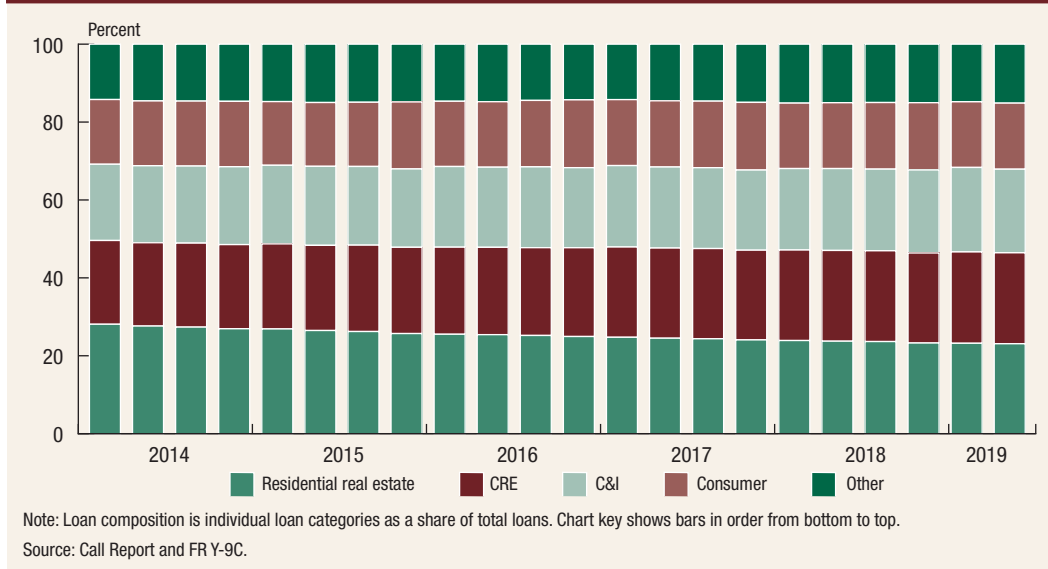
Total loans outstanding within the banking industry continue to increase. Commercial and industrial (C&I) and commercial real estate (CRE) loans have demonstrated particularly strong growth, both rising over the past five years (figure 1). Of these two forms of lending, the C&I category has shown the greatest strength over the past year.

Concentration of bank lending continues to evolve. The share of loans at the largest and most complex banks—those overseen by the Large Institution Supervision Coordinating Committee (LISCC) (see table 1)—has declined gradually. As of the second quarter of 2019, domestic LISCC firms held around 40 percent of the banking industry’s loans outstanding (figure 2), down from 46 percent in the first quarter of 2014. The decline in lending market share of LISCC firms largely reflects an expanding market position of regional banking organizations (RBOs).



CRE loans are now the largest category of lending by U.S. banking organizations (figure 3). The share of loans backed by residential real estate has declined steadily in recent years, as nonbank lenders increase their market share. Residential real estate loans had historically made up the largest share of total loan holdings before the first quarter of 2019.

**Figure 3. Loan composition**

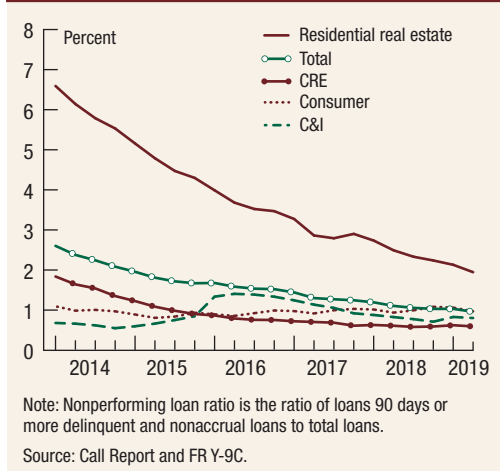


*Loan performance is stable overall, but with some areas of concern.*

The Federal Reserve continues to monitor the quality of loans held on bank balance sheets. Currently, nonperforming loans as a share of total loans and leases are low, at about 1 percent, and nonperforming loan ratios are improving or mostly stable for the banking system as a whole (figure 4).

The reserve coverage ratio—or the ratio of allowance for loan and lease losses (or ALLL, which is the amount of reserves banks set aside to absorb losses related to troubled loans) to the volume of nonperforming loans and leases held by a bank—has risen steadily since the first quarter of 2014, as nonperforming loans have declined (figure 5). A higher ratio generally indicates a better ability to absorb future loan losses.

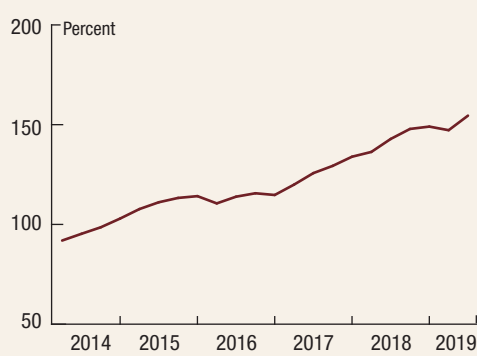
**Figure 4. Nonperforming loan ratio**



While the overall trend in credit quality appears favorable, some areas of concern bear closer monitoring. The nonperforming ratio for consumer loans has trended upward slightly since mid-2015, rising about 20 basis points overall, although it remains low by historical standards.

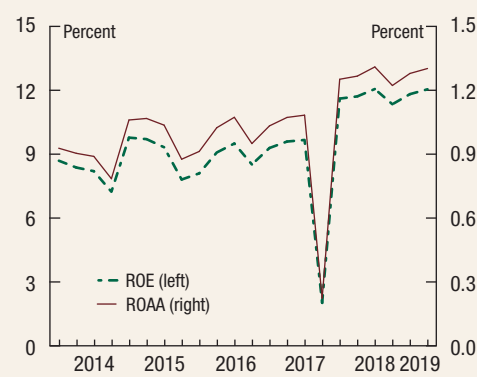
*Profitability is robust.*

While bank profitability has plateaued in recent quarters, overall profits for the banking industry nevertheless stand at substantially improved levels relative to five years ago. Two

**Figure 5. Reserve coverage ratio**

Note: Reserve coverage ratio is the ratio of ALLL to loans 90 days or more delinquent and nonaccrual loans. Data adjusted for Ginnie Mae guaranteed loans.

Source: Call Report and FR Y-9C.

**Figure 6. Bank profitability**

Note: ROAA is net income/quarterly average assets; ROE is net income/average equity capital. Values are annualized.

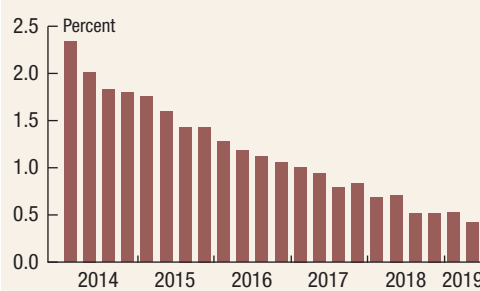
Source: Call Report and FR Y-9C.

important measures of profitability—return on equity (ROE) and return on average assets (ROAA)—have increased roughly 40 percent since the first quarter of 2014 (figure 6).<sup>1</sup>

### *Firms continue to maintain strong capital and liquidity.*

Strong capital helps to ensure that banks can absorb unexpected losses and support the economy, including during an economic downturn. Aggregate capital levels for the domestic supervisory portfolios have remained strong since 2014, in some cases rising slightly over the past year (figure 10 and figure 17). Meanwhile, the share of institutions not well-capitalized has declined over the past five years and, as of the second quarter of 2019, amounted to only about one-half percent (figure 7).

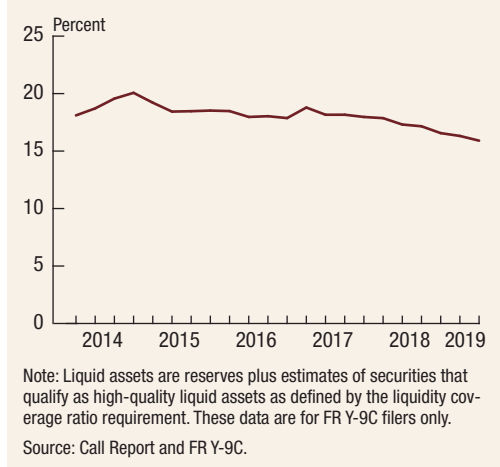
Besides capital, another critical ingredient to a resilient banking system is liquidity. Firms are required to maintain adequate levels of highly liquid assets (cash and securities easily convertible to cash) to be able to meet their obligations, even during times of financial stress. While the banking industry's holdings of liquid assets (reserves plus securities that qualify as high-quality liquid assets) declined slightly over the past several years, as of the second quarter of 2019, they remain substantially higher than before the financial crisis (at the beginning of 2007, this ratio was less than 3 percent) (figure 8).

**Figure 7. Share of institutions not well-capitalized**

Source: Call Report and FR Y-9C.

<sup>1</sup> The dip in ROE and ROAA in the fourth quarter of 2017 was driven by a one-time tax effect associated with the Tax Cuts and Jobs Act of 2017.

**Figure 8. Liquid assets as a share of total assets**

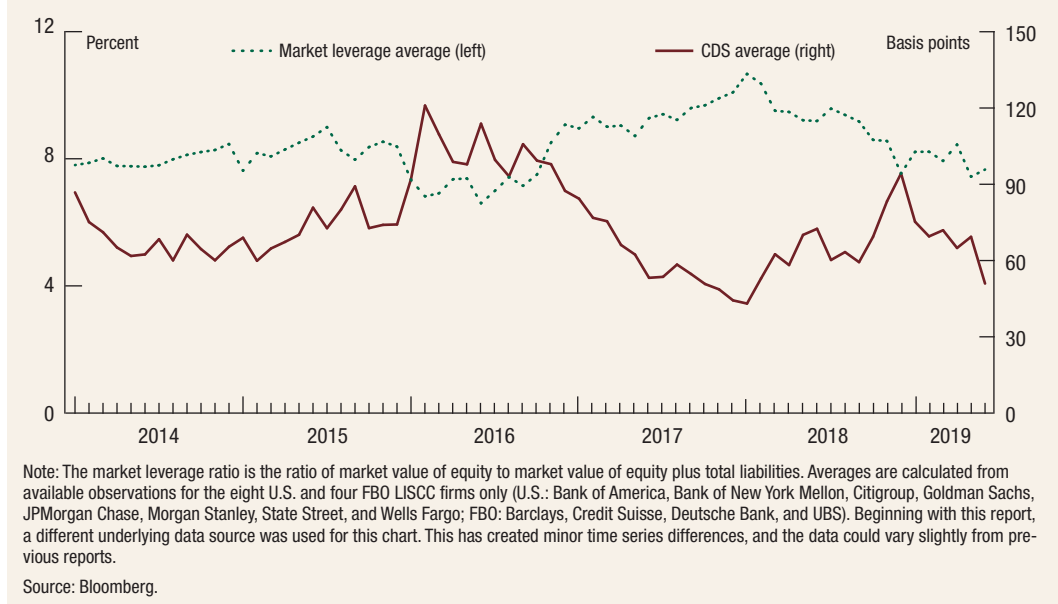


*Key market indicators reflect confidence.*

Strong performance of the U.S. financial system is reflected in the current level of market-based indicators of bank health, such as the market leverage ratio and credit default swap (CDS) spreads. The market leverage ratio is a market-based measure of a bank’s capital position, where a higher ratio generally indicates investor confidence in a bank’s financial strength. CDS spreads are a measure of market perceptions of bank risk, and a small spread reflects investor confidence in a bank’s financial health. Both measures currently indicate market confidence in the banking system. CDS spreads of LISCC firms have fallen through the first half of 2019. Market leverage

ratios, which had declined in 2018, have stabilized during 2019 (figure 9).

**Figure 9. Average credit default swap (CDS) spread and market leverage ratio**



**Table 1. Summary of organizations supervised by the Federal Reserve (as of 2019:Q2)**

Portfolio	Definition	Number of institutions	Total assets (\$trillions)
Large Institution Supervision Coordinating Committee (LISCC)	Eight U.S. global systematically important banks (G-SIBs) and four foreign banking organizations (FBOs) with large and complex U.S. operations	12	12.4
State member banks (SMBs)	SMBs within LISCC organizations	5	0.8
Large and foreign banking organizations (LFBOs)	Non-LISCC U.S. firms with total assets \$100 billion and greater and non-LISCC FBOs	177	7.4
Large banking organizations (LBOs)	Non-LISCC U.S. firms with total assets \$100 billion and greater	17	3.5
Large FBOs	Non-LISCC FBOs with combined U.S. assets \$100 billion and greater	13	2.7
Small FBOs	Non-LISCC FBOs with combined assets less than \$100 billion	147	1.2
State member banks	SMBs within LFBO organizations	8	1.0
Regional banking organizations (RBOs)	Total assets between \$10 billion and \$100 billion	88	2.1
State member banks	SMBs within RBO organizations	49	0.7
Community banking organizations (CBOs)	Total assets less than \$10 billion	3,900*	2.5
State member banks	SMBs within CBO organizations	719	0.5
Insurance and commercial savings and loan holding companies (SLHCs)	SLHCs primarily engaged in insurance or commercial activities	7 insurance 4 commercial	1.0

Source: Call Report, FFIEC 002, FR 2320, FR Y-7Q, FR Y-9C, FR Y-9SP, and S&P Global Market Intelligence.

\* Includes 3,835 holding companies and 65 state member banks that do not have holding companies.

### **Box 1. LIBOR Transition**

An area of change that the Federal Reserve is monitoring involves risks associated with the transition away from the use of London Interbank Offered Rate (LIBOR).

LIBOR is currently used throughout the banking system as a reference to determine the interest rate on a variety of financial products, such as derivatives and loans to businesses and consumers. In July 2017, the U.K. Financial Conduct Authority, which has regulated LIBOR since 2013, announced that it intended to preserve LIBOR's continued publication by reaching a voluntary agreement with the remaining panel banks to continue submissions through the end of 2021, but it will neither seek to persuade nor compel panel banks to participate in LIBOR panels after year-end 2021. This announcement indicates that LIBOR could cease to exist after 2021, which would have ramifications for its use as the benchmark reference rate for an estimated \$200 trillion in U.S. dollar exposures and \$370 trillion globally.

The anticipated end to LIBOR will necessitate the transition to alternative reference rates, while seeking to minimize any potential harm to consumers and manage any associated legal or reputational risks. The transition away from LIBOR will be a complex and challenging undertaking and will require significant attention and priority over the next several years to avoid disruption and manage associated safety and soundness risks. For example, risk management, monitoring systems, and models that depend on LIBOR as an input will likely need to be updated. Financial contracts linked to LIBOR may need to be updated to be sufficiently robust to withstand a transition away from the use of LIBOR.

The size of such transition tasks points to the importance of current planning and risk-mitigation efforts. Senior management at financial institutions are in the best position to assess and manage the range of firm-specific risks that may arise over the course of the transition.



# Regulatory Developments

The Federal Reserve is focused on maintaining a safe, sound, and efficient financial system while simplifying the regulatory framework and minimizing compliance burden.

In particular, the Board continues to tailor regulations, as appropriate, and implement provisions of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). As summarized in [table 2](#), over the past 12 months, the Board proposed 14 rules and guidance, finalized 16 rules and guidance, issued 1 request for information, and issued 6 Federal Reserve and interagency supervisory statements.

Table 2. Federal Reserve or interagency rulemakings/statements (proposed and final)	
Date issued	Rule/guidance
12/4/2018	Agencies invite public comment on proposal to raise appraisal exemption threshold for residential real estate transactions, as part of EGRRCPA. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181204a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181204a.htm</a>
12/21/2018	Agencies issue final rules expanding examination cycles for qualifying small banks and U.S. branches and agencies of foreign banks, as part of EGRRCPA. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181221c.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181221c.htm</a>
12/21/2018	Agencies invite public comment on a proposal to exclude community banks from the Volcker rule, as part of EGRRCPA. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181221d.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181221d.htm</a>
1/8/2019	Board invites public comment on proposal that would modify company-run stress testing requirements to conform with EGRRCPA. Board press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190108a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190108a.htm</a>
2/5/2019	Board finalizes set of changes that will increase the transparency of its stress testing program for nation's largest and most complex banks. Board press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190205a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190205a.htm</a>
3/6/2019	Board announces it will limit the use of the "qualitative objection" in its Comprehensive Capital Analysis and Review (CCAR) exercise, effective for the 2019 cycle. Board press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190306b.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190306b.htm</a>
3/15/2019	Agencies adopt interim final rule to facilitate transfers of legacy swaps. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190315a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190315a.htm</a>
4/2/2019	Agencies invite public comment on a proposed rule to limit the interconnectedness of large banks and reduce the impact from failure of the largest banks. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190402a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190402a.htm</a>
4/8/2019	Board invites public comment on changes to the regulatory framework that would more closely match rules for foreign banks with the risks they pose to U.S. financial system. Board press release and visuals: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190408a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190408a.htm</a>
4/16/2019	Agencies invite comment on modifications to resolution plan requirements as part of EGRRCPA. The proposal keeps existing requirements for largest firms and reduces requirements for firms with less risk. Interagency press release and visuals: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190416a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190416a.htm</a>

(continued)

**Table 2.—continued**

Date issued	Rule/guidance
4/18/2019	Agencies invite public comment on revisions to the supplementary leverage ratio as required by EGRRCPA. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190418a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190418a.htm</a>
4/23/2019	Board invites public comment on proposal to simplify and increase the transparency of rules for determining control of a banking organization. Board press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190423a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190423a.htm</a>
5/3/2019	Board invites public comment on a proposal to apply netting protections to a broader range of financial institutions. Board press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190503a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190503a.htm</a>
5/9/2019	Board approves final rule to repeal regulations that incorporated the Secure and Fair Enforcement for Mortgage Licensing Act. Banking institutions that were subject to the Board's rules are now subject to rules from the Consumer Financial Protection Bureau. Board press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190509a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190509a.htm</a>
5/30/2019	Agencies issue final rule regarding the treatment of certain municipal obligations as high-quality liquid assets as part of EGRRCPA. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190530a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190530a.htm</a>
6/17/2019	Agencies issue final rule to streamline regulatory reporting requirements and commit to further review of reporting burdens for small institutions as part of EGRRCPA. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190617a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190617a.htm</a>
6/21/2019	Board releases results of 2019 Dodd-Frank Act stress tests. The banks tested had strong capital levels that would allow them to stay well above their minimum requirements after being tested against a severe hypothetical recession. Board press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190621a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190621a.htm</a>
6/27/2019	Board releases results of its 2019 Comprehensive Capital Analysis and Review stress test. The banks tested had strong capital levels and virtually all are now meeting the Board's supervisory expectations. Board press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190627a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190627a.htm</a>
7/9/2019	Agencies issue final rule to simplify regulatory capital rules. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190709a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190709a.htm</a>
7/12/2019	Agencies invite public comment on a proposed rule on the capital treatment of land development loans as part of EGRRCPA. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190712a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190712a.htm</a>
7/17/2019	Agencies announce coordination of reviews for certain foreign funds under the Volcker rule. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190717a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190717a.htm</a>
7/22/2019	Agencies and FinCEN improve transparency of risk-focused BSA/AML supervision. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190722a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190722a.htm</a>
7/26/2019	Agencies release public sections of resolution plans for eight large banks. Agencies complete resolution plan evaluations and extend deadline for certain firms. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190726a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190726a.htm</a>
9/6/2019	Board invites public comment on proposal to establish capital requirements for certain insurance companies supervised by the Board. Board press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190906a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190906a.htm</a>

(continued)

**Table 2.—continued**

Date issued	Rule/guidance
9/27/2019	Agencies issue final rule to exempt residential real estate transactions of \$400,000 or less from appraisal requirements as part of EGRRCPA. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190927a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190927a.htm</a>
10/2/2019	Agencies issue final rule to update rules restricting the ability of a director or other management official to serve at more than one depository institution, known as management interlock rules. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191002a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191002a.htm</a>
10/8/2019	Agencies finalize changes to simplify the Volcker rule. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191008a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191008a.htm</a>
10/10/2019	Board finalizes rules that tailor its regulations for domestic and foreign banks to more closely match their risk profiles as part of EGRRCPA. The rules reduce compliance requirements for firms with less risk while maintaining the most stringent requirements for the largest and most complex banks. Board press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191010a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191010a.htm</a>
10/17/2019	Agencies seek comment on proposed interagency policy statement on allowances for credit losses and proposed interagency guidance on credit risk review systems. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191017a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191017a.htm</a>
10/18/2019	Agencies request information on use and impact of CAMELS ratings. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191018a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191018a.htm</a>
10/28/2019	Agencies finalize changes to resolution plan requirements as part of EGRRCPA. The rules maintain requirements for the largest firms and reduce requirements for smaller firms. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191028b.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191028b.htm</a>
10/28/2019	Agencies invite comment on proposal to amend swap margin rules. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191028a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191028a.htm</a>
10/29/2019	Agencies issue final rule to simplify capital calculation for community banks (community bank leverage ratio). Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191029a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191029a.htm</a>
11/08/2019	Board invites public comment on proposal to extend by 18 months initial compliance dates for foreign banks subject to its single-counterparty credit limit rule. Board press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191108a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191108a.htm</a>
11/19/2019	Agencies finalize changes to supplementary leverage ratio as required by EGRRCPA. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191119a.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191119a.htm</a>
11/19/2019	Agencies issue final rule on treatment of high-volatility commercial real estate. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191119b.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191119b.htm</a>
11/19/2019	Agencies finalize rule to update calculation of counterparty credit risk for derivative contracts. Interagency press release: <a href="https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191119c.htm">https://www.federalreserve.gov/newsevents/pressreleases/bcreg20191119c.htm</a>

**Box 2. Final Rules to Tailor Prudential Standards for Large Domestic and Foreign Banking Organizations**

The Federal Reserve Board on October 10, 2019, finalized rules that tailor its regulations for domestic and foreign banks to more closely match their risk profiles. The rules reduce compliance requirements for firms with less risk while maintaining the most stringent requirements for the largest and most complex banks.

The rules establish a framework that sorts banks with \$100 billion or more in total assets into four different categories based on several factors, including asset size, cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, and off-balance-sheet exposure. Significant levels of these factors result in risk and complexity to a bank and can, in turn, bring risk to the financial system and broader economy.

The rules build on the Board's existing practice of tailoring its requirements and are consistent with changes made by EGRRCPA.

Separately, the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC) on October 28, 2019, announced that they had finalized a rule that modifies their resolution plan requirements for large firms. The rule retains resolution plan elements in place for the largest firms, while reducing requirements for smaller firms that pose less risk to the financial system.

# Supervisory Developments

This section provides an overview of key developments related to the Federal Reserve’s prudential supervision of financial institutions, including large financial institutions (LISCC firms and LFBOs) as well as regional and community banking organizations.

The Federal Reserve is also responsible for timely and effective supervision of consumer protection and community reinvestment laws and regulations. Consumer-focused supervisory work is designed to promote a fair and transparent financial services marketplace and to ensure that the financial institutions under the Federal Reserve’s jurisdiction comply with applicable federal consumer protection laws and regulations. The scope of the Federal Reserve’s supervisory jurisdiction varies based on the particular law or regulation and on the asset size of the state member bank.

More information about the Federal Reserve’s consumer-focused supervisory program can be found in the Federal Reserve’s *105th Annual Report 2018*.<sup>2</sup> The Federal Reserve also publishes the *Consumer Compliance Supervision Bulletin*, which shares information about examiners’ supervisory observations and other noteworthy developments related to consumer protection.<sup>3</sup>

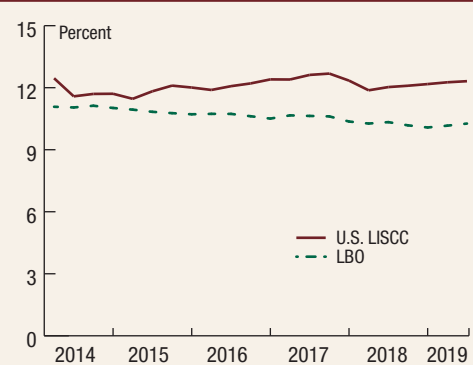
## Large Financial Institutions

This section of the report discusses issues and priorities related to the supervision of firms in the LISCC and LFBO portfolios.

*The safety and soundness of large financial institutions continue to improve.*

Large financial institutions are in sound financial condition, although nonfinancial weaknesses remain. As of the second quarter of 2019, common equity tier 1 capital levels remain strong, at over 12 percent of risk-weighted assets for LISCC domestic firms and over 10 percent of risk-weighted assets for LBOs (figure 10). Recent stress test results show that the capital levels of large firms after a hypothetical severe recession would remain above regulatory minimums (figure 11).

**Figure 10. Large financial institution common equity tier 1 ratio**



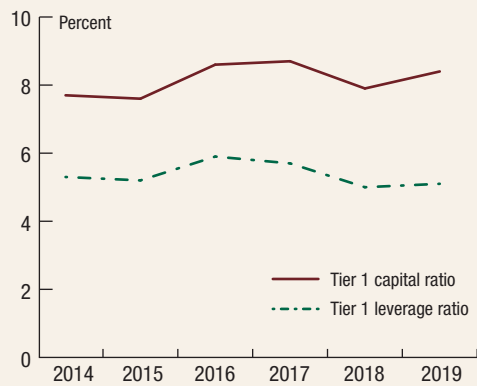
Note: Common equity tier 1 ratio is the ratio of tier 1 common equity to risk-weighted assets.

Source: Call Report and FR Y-9C.

<sup>2</sup> See *105th Annual Report 2018*, section 5, “Consumer and Community Affairs,” at <https://www.federalreserve.gov/publications/annual-report.htm>.

<sup>3</sup> See *The Consumer Compliance Supervision Bulletin* at <https://www.federalreserve.gov/publications/consumer-compliance-supervision-bulletin.htm>.

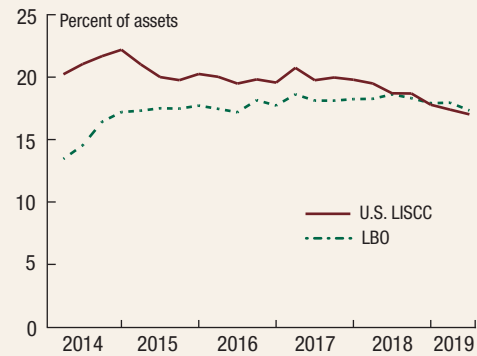
**Figure 11. CCAR post-stress capital ratios**



Note: Results of CCAR supervisory post-stress capital analysis (2014–19). Federal Reserve estimates of capital ratios in the severely adverse scenario. Regulatory minimum tier 1 capital ratio is 6.0 percent. Regulatory minimum tier 1 leverage ratio is 4.0 percent.

Source: CCAR public disclosure documents.

**Figure 12. Large financial institution liquid assets**

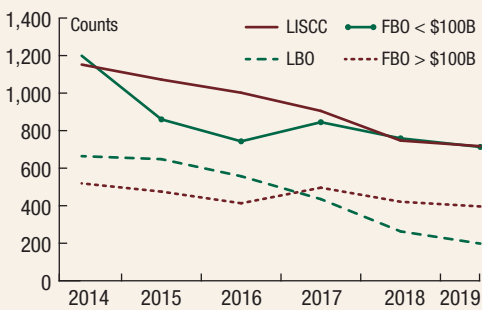


Note: Liquid assets are reserves plus estimates of securities that qualify as high-quality liquid assets as defined by the liquidity coverage ratio requirement. Data only include firms that were designated as domestic LBO or U.S. LISCC as of 2019:Q2. Data do not include SLHCs.

Source: Call Report and FR Y-9C.

Although liquidity buffers declined slightly in recent quarters, large financial institutions continue to maintain adequate liquid assets. Liquid assets make up approximately 17 percent of total assets for both U.S. LISCC firms and LBOs (figure 12). Currently, all large financial institutions regulated by the Federal Reserve maintain enough liquid assets to withstand a month of stressed liquidity outflow.<sup>4</sup>

**Figure 13. Outstanding supervisory findings, large firms and FBOs**



Note: Values prior to 2019 are as of year-end. The 2019 value is as of the end of 2019:Q2. The findings count data are subject to revisions as issues are reviewed, updated, and finalized; this could result in minor historical count fluctuations.

Source: Internal Federal Reserve supervisory databases.

Large financial institutions continue to remediate a significant number of supervisory findings (matters requiring attention (MRAs) or matters requiring immediate attention (MRIAs)). As a result, the number of outstanding supervisory findings has decreased over the past year for all groups of domestic and foreign firms (figure 13).

*Material risk-management weaknesses persist at a number of firms.*

Supervisory ratings for large firms have generally held steady over the past year (figure 14). Firms with less-than-satisfactory ratings generally exhibit weaknesses in one or more areas such as compliance, internal controls, model

<sup>4</sup> As required by the liquidity coverage ratio rule. See <https://www.govinfo.gov/content/pkg/FR-2014-10-10/pdf/2014-22520.pdf>.

### Box 3. New Supervisory Rating System

Following the 2007–09 financial crisis, the Federal Reserve developed a supervisory program designed to enhance resiliency and address financial stability risks posed by large financial institutions. Following these changes, the Federal Reserve designed and adopted a new rating system that closely aligns with the current supervisory program and practices.<sup>1</sup>

The rating system applies to

- U.S. bank holding companies (BHCs) with total consolidated assets of \$100 billion or more,
- noninsurance, noncommercial SLHCs with total consolidated assets of \$100 billion or more, and
- U.S. intermediate holding companies (IHCs) of foreign banking organizations with total consolidated assets of \$50 billion or more.

The Federal Reserve assigned initial ratings to LISCC firms in early 2019 and will assign ratings to LFBO firms in early 2020. Smaller banks will continue to be rated using the RFI rating system.

Under the new rating system, the Federal Reserve will assign three component ratings:

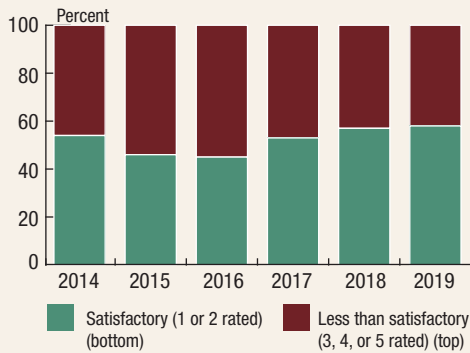
- capital planning and positions
- liquidity risk management and positions
- governance and controls

In contrast to the prior rating system, the new rating system does not assign a standalone composite or subcomponent rating.

The new system uses a four-category rating system:

- The **Broadly Meets Expectations** rating indicates that the firm is in safe and sound condition.
- The **Conditionally Meets Expectations** rating indicates that certain material, financial, or operational weaknesses in a firm’s practices or capabilities may place the firm’s prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.
- The **Deficient-1** rating indicates that financial or operational deficiencies in a firm’s practices or capabilities put the firm’s prospects for remaining safe and sound through a range of conditions at significant risk.
- The **Deficient-2** rating indicates that financial or operational deficiencies in a firm’s practices or capabilities present a threat to the firm’s safety and soundness or have already put the firm in an unsafe and unsound condition.

<sup>1</sup> See SR 19-3 / CA 19-2 Letter, Large Financial Institution (LFI) Rating System at <https://www.federalreserve.gov/supervisionreg/srletters/sr1903.htm>

**Figure 14. Holding company ratings for firms > \$100 billion**

Source: Internal Federal Reserve supervisory databases. All ratings information reflects RFI ratings, except 2019 LISCC ratings, which reflect ratings under the LFI rating system. Under the LFI rating system, firms which are classified as “Deficient-1” or “Deficient-2” in any of the three assessment areas are categorized as “Less-than-satisfactory.”

risk management, operational risk management, and/or data and information technology (IT) infrastructure. Some firms also continue to exhibit weaknesses in their Bank Secrecy Act (BSA) and anti-money-laundering (AML) programs.

### Supervision of LISCC Firms

*In general, LISCC firms are continuing to improve in key areas.*

The overall safety and soundness of LISCC firms continue to improve. LISCC firms maintain capital levels above regulatory capital requirements, and this year the Board did not

### Box 4. Stress Testing Conference

In 2009, the Supervisory Capital Assessment Program, or SCAP, helped restore market confidence in the largest banks. Since then, stress tests have become an important supervisory and financial stability tool and have continued to evolve based on feedback from a wide range of stakeholders.

On July 9, 2019, the Federal Reserve hosted the “Stress Testing: A Discussion and Review” conference, bringing together academic researchers, bankers, regulators, and other stakeholders to discuss the present and future state of bank stress testing as a policy tool. The conference was broadcast live via webcast to enhance transparency.

The conference was organized into three panel sessions devoted to the following themes:

- the effectiveness of stress testing as a policy tool,
- transparency and how to keep stress testing dynamic and effective in an evolving economy, and
- the effect of stress testing on the banking sector and the real economy (e.g., bank risk-taking and capital allocation, and the access to, and pricing of, credit).

The conference proceedings highlighted a number of issues that will likely inform policy development related to the Federal Reserve’s stress test and capital regulation. These issues included the role of stress testing in normal economic times versus its role in stressful economic conditions, the tradeoffs between transparency and dynamism, and the role of stress testing as a countercyclical tool.

The full set of conference materials and a video of the conference proceedings are available here: <https://www.federalreserve.gov/conferences/stress-testing-a-discussion-and-review.htm>.



object to the capital plans of any LISCC firm as part of CCAR.<sup>5</sup> LISCC firms also generally have adequate liquidity positions.

Firms in this portfolio remain focused on improving governance practices and effectively managing compliance and operational risks. Both supervisors and the firms have increased attention to operational resilience, including business continuity planning.

*The number of supervisory findings issued to LISCC firms, as well as the number outstanding, has declined over the past five years.*

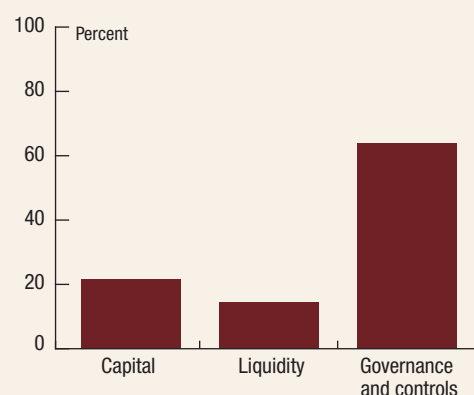
The number of supervisory findings issued by the Federal Reserve per year has steadily declined over the past five years.<sup>6</sup> During the same period, as firms implemented and sustained improvements in governance, risk management, and controls, more supervisory findings were closed than were issued, resulting in an overall 35 percent reduction in outstanding findings. The number of supervisory findings issued by the Federal Reserve in any given period will vary somewhat depending on contemporaneous regulations, policies, and practices. However, the general trend in the overall level of supervisory findings indicates improved risk management at LISCC firms.

*Weaknesses persist, particularly in governance and controls.*

Over half of the supervisory findings issued in the past five years were related to governance and risk-management control issues. Of the supervisory findings currently outstanding, over 60 percent relate to this category of issues, including weaknesses in firms' BSA/AML programs, internal audit functions, IT risk management (including cybersecurity), and model risk management (figure 15). There are also a number of outstanding supervisory findings related to how firms gather, validate, and report data for regulatory purposes.

Over the past year, the percentage of outstanding supervisory findings related to governance and control issues has increased slightly. This is consistent with supervisory concerns regarding weaknesses in these areas and improvements in capital planning and liquidity. Supervisory work shows that firms are in different stages of improving their technology platforms and data quality and controls.

**Figure 15. Outstanding supervisory findings by category, LISCC firms**



Note: As of 2019:Q2, there were 717 total outstanding supervisory findings for LISCC firms.

Source: Internal Federal Reserve supervisory databases.

<sup>5</sup> See the Federal Reserve 2019 CCAR press release at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190627a.htm>.

<sup>6</sup> Note that supervisory findings related to resolution plans are not classified as MRAs or MRIAs. Shortcomings and deficiencies found in firm-specific resolution plans can be found at <https://www.federalreserve.gov/supervisionreg/resolution-plans.htm>.

*Improvements are also required in other areas.*

With regard to capital, outstanding supervisory findings relate to firms' methods for developing assumptions used in internal stress tests and internal governance of capital models, as well as some areas of credit risk management. Federal Reserve supervisors have also asked some firms to make additional improvements in liquidity risk management to fully meet supervisory expectations. Examples include internal stress tests and cash flow forecasting capabilities.

With regard to resolution planning for LISCC domestic firms, certain weaknesses were highlighted by the Federal Reserve in 2017, including the feasibility of selling off business units under stress, complexity in derivatives portfolios, and issues around legal entity structures. The Federal Reserve Board and the FDIC are currently reviewing the resolution plans submitted in July 2019 by these firms.<sup>7</sup>

In December 2018, the Federal Reserve Board and the FDIC identified areas for improvement in the resolution plans of the four foreign-based LISCC firms, including weaknesses in how each firm communicates and coordinates between its U.S. operations and its foreign parent in stress.<sup>8</sup> These firms are required to submit resolution plan updates related to the remediation of these weaknesses in July 2020.

*Changes in technology, the competitive environment, and some firms' business models highlight the importance of supervisory monitoring.*

As firms look to the future and formulate their strategic plans, supervisors will focus on emerging vulnerabilities. Supervisors will monitor how banks implement appropriate governance and controls as operations and businesses change because of external factors, such as Brexit, and internal drivers, such as shifts in business focus. For example, supervisors will be following trends in firms' search for yield, possibly resulting in growing complexity of investment products and greater vulnerabilities to liquidity shocks.

Rapidly occurring changes in technology present opportunities for firms as well as threats. Supervisors will be following developments in information technology, cybersecurity, and data management, such as the increasing use of third-party cloud services, artificial intelligence, and evolving retail digital platforms. Examples of potential impacts on firms include increased competition for core customer relationships and volatile or reduced revenues due to technology challenges in certain business lines.

***Supervisory Priorities for 2020***

In 2020, supervisors will be reviewing emerging risks and their potential impact on LISCC firms and will continue to conduct cross-firm and firm-specific supervisory examinations for firms within the LISCC portfolio. In addition, supervisors will review actions firms have taken to address safety and soundness weaknesses previously identified in existing supervisory findings and outstanding public enforcement actions (box 5).

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<sup>7</sup> See the Federal Reserve press release at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190723a.htm>.

<sup>8</sup> See the Federal Reserve press release at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181220c.htm>.

### Box 5. Upcoming LISCC Supervisory Priorities

#### Capital

- practices supporting stressed loss/revenue forecasting
- underwriting standards
- credit risk management
- current expected credit loss (CECL) implementation

#### Liquidity

- internal liquidity stress test assumptions
- liquidity position
- risk management and governance, for example for liquidity data and new products
- compliance with liquidity regulation

#### Governance and controls

- operational resilience of critical systems
- information technology and cyber-related risks
- compliance risk management
- internal audit
- LIBOR preparedness

#### Recovery and resolution planning

- LISCC domestic firm resolution plans follow-up (as needed)
- LISCC foreign bank IHC resolution shortcoming remediation plans
- preparation for LISCC firm targeted resolution plans
- recovery planning

## Supervision of Large and Foreign Banking Organizations

*Overall, large and foreign banking organizations remain safe and sound.*

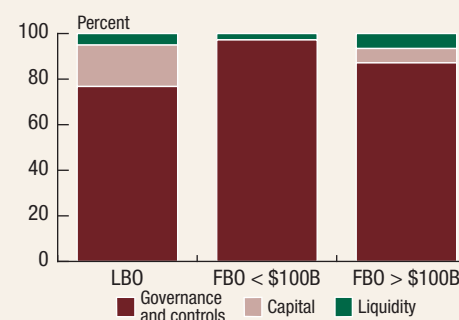
LFBOs continue to meet supervisory expectations for capital and liquidity. The majority of supervisory concerns for this portfolio of firms are concentrated in the area of governance and controls. For LFBO firms, outstanding supervisory findings declined approximately 20 percent between June 2018 and June 2019.

*Nonfinancial risks continue to be the most significant findings identified in the LFBO portfolio.*

For LFBO firms, including all FBOs, over 90 percent of supervisory findings outstanding are related to governance and controls (figure 16). Areas of concern continue to include compliance control deficiencies from long-standing BSA/AML issues, as well as IT risk management issues. The majority of public enforcement actions currently open for LFBO firms are related to BSA/AML and Office of Foreign Asset Control (OFAC) compliance.

Findings opened over the last year continue to center around IT risk management topics such as cybersecurity and information security programs, including patch management, penetration testing, and privacy. Weaknesses in firms' disaster recovery/business continuity planning

**Figure 16. Outstanding supervisory findings by category, LBO and non-LISCC FBO firms**



Note: As of 2019:Q2, total supervisory findings, by portfolio, were: LBO - 198; FBO > \$100B - 396; FBO < \$100B - 713. Chart key shows bars in order from bottom to top.

Source: Internal Federal Reserve supervisory databases.

and risk management have also been identified. Compliance issues related to BSA/AML and OFAC continue, particularly within FBO branches and agencies that are at inherently higher risk for BSA/AML exposures.

*Capital and liquidity planning, risk management, and positions remain within supervisory expectations.*

The majority of LFBO firms have capital planning that is appropriate for their risk profiles. Although improvement in firms' practices is noted in a range of areas, one area of supervisory concern remains around loss projection methodologies. While the majority of firms have appropriate methodologies, a few firms need improvement in loss projection methodologies for large loan exposures and model adjustment governance.

Most domestic LBO and large FBO firms have established appropriate liquidity risk management practices that are consistent with supervisory expectations and regulations. That said, for some large FBOs, insufficient support for certain underlying assumptions for liquidity stress testing practices, such as for funding of off-balance-sheet commitments, was noted.

*Opportunities for improvement in credit risk management have been identified.*

Federal Reserve examiners have recently observed some credit risk management issues in the LFBO portfolio, including weaknesses in credit administration (such as policies and procedures related to underwriting, and risk and data reporting), and independent loan review functions. The Federal Reserve will continue to monitor this area and issue supervisory findings as appropriate.

### **Box 6. Upcoming LFBO Supervisory Priorities**

#### **Capital**

- capital planning and risk management, including credit loss estimation and governance
- wholesale credit underwriting and controls and independent loan review functions
- CECL implementation

#### **Liquidity**

- internal liquidity stress testing assumptions and business-as-usual cash flow projections
- governance over liquidity data
- daily and short-term liquidity risk management monitoring programs

#### **Governance and controls**

- cyber-related and information technology risks
- BSA/AML programs and OFAC compliance
- third-party or vendor risk management
- LIBOR preparedness

#### *Supervisory Priorities for 2020*

For the LFBO portfolio, planning for 2020 supervisory efforts is under way. Capital, liquidity, and governance and controls supervisory activity in 2020 will address regulatory changes arising from the final tailoring rules. For nonfinancial risks, examiners will conduct a combination of horizontal reviews and firm-specific target reviews, in addition to continuous monitoring efforts. For the portfolio as a whole, the supervisory focus will be on the areas listed in [box 6](#).

### **Regional and Community Banking Organizations**

*The majority of the firms in the regional and community bank portfolios are in satisfactory condition.*

Regional and community banking organizations are generally in satisfactory financial condition. Aggregate common equity tier 1

### Box 7. Supervisory Communications—MRAs, MRIAs, and Enforcement Actions

The Federal Reserve has various tools available to ensure that banking organizations operate both in compliance with all applicable laws and regulations and in a safe and sound manner. Examiners use a number of channels to identify and communicate areas where banking organizations do not meet supervisory expectations.

**Table A. Supervisory communication channels**

Degree of severity	Communication channel	Description
Least severe (top) to most severe (bottom)	<b>Supervisory findings</b>	MRAs are a call for action to address weaknesses that could lead to deterioration in a banking organization's soundness. MRAs are confidential and not publicly issued.
		MRIAs are a call for more immediate action to address acute or protracted weaknesses that could lead to further deterioration in a banking organization's soundness, may result in harm to consumers, or have caused, or could lead to, noncompliance with laws and regulations. MRIAs are confidential and not publicly issued.
	<b>Enforcement actions</b>	Informal enforcement actions are not public and are used when circumstances warrant a less severe form of action than a formal action.
		Formal enforcement actions are publicly issued actions designed to prevent, deter, and correct violations of law and unsafe and unsound banking practices.

MRAs and MRIAs are not enforcement actions.

It is typically the case that MRAs or MRIAs are the first step in communicating supervisory findings to a banking organizations and are done so through the report of examination. Most MRAs and MRIAs are resolved without the need to escalate.

If it is determined that there is a need to escalate to an enforcement action, among the factors considered by the Federal Reserve are

- the overall condition of the institution; and
- whether or not the deficiency has been cited in a prior MRIA or an MRA that the examiners have determined has not been remediated.

Generally, MRIAs serve as the basis for the provisions included in an enforcement action. There may be a few cases where some issues are so acute they require immediate issuance of an enforcement action.

Enforcement actions can be informal or formal. Informal enforcement actions include commitment letters, board resolutions, and memoranda of understanding. Formal enforcement actions include written agreements and cease and desist orders. Formal enforcement actions are publicly issued actions designed to prevent, deter, and correct violations of law and unsafe and unsound banking practices. These actions derive from, and carry the full weight and enforceability of law.

### Box 8. The Shared National Credit Program

The Shared National Credit (SNC) program is an interagency supervisory program employed by the Federal Reserve, the FDIC, and the OCC (“the agencies”) to assess more than \$5 trillion in wholesale commercial credit exposures within the financial system, including leveraged loans. The SNC program assesses credit risk and trends as well as underwriting and risk-management practices associated with the largest and most complex loans shared by multiple regulated financial institutions. Since the program facilitates a single review of loan exposures held by multiple firms, it provides for uniform treatment and increased efficiency in credit risk analysis and classification.

While lending exposures from all major sectors are reviewed, the SNC program’s semiannual examinations may focus on specific sectors based on early warning signs from emerging risks. In recent years, examiner attention has been drawn toward oil and gas lending, CRE exposures, large national retail businesses, and loans to nonbank financial institutions. In the third quarter of 2019, the SNC exam again looked at bank leveraged lending activity, as well as targeted loans to oil and gas extraction and service-related companies.

The credit quality of loans in the SNC portfolio improved in 2018, largely because of improving economic conditions in the oil and gas sector. Despite the improvement, credit quality metrics of the overall SNC portfolio remain modestly weaker compared with similar periods in prior economic cycles. A significant portion of these weaker loans are concentrated in transactions identified as leveraged loans. In contrast to the overall portfolio, risks associated with leveraged lending activities are building. The agencies have found that while bank practices with respect to leveraged lending have improved in several areas since 2014, other lending practices have emerged that are cause for supervisory concern and may not be well monitored through bank internal risk-management practices.

Through the examination process, the agencies remind banks that risk management must evolve as market conditions change and new risk vectors emerge. While the proportion of SNC loans with weakened repayment capacity is relatively low today, leveraged borrowers are highly susceptible to changes in the economy, and a downturn could result in a significant increase in problem loan exposures and higher financial losses. As such, the agencies will remain focused for the foreseeable future on assessing the impact of leveraged loans on firms’ asset quality.

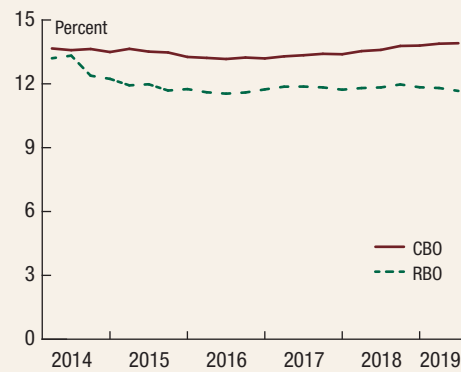
capital remains strong, at nearly 12 percent of risk-weighted assets for RBOs and 14 percent of risk-weighted assets for CBOs, as of the second quarter of 2019 (figure 17). Less than 1 percent of organizations in these portfolios report capital levels that do not meet the “well-capitalized” designation.

Management and risk-management practices are generally satisfactory. Outstanding supervisory findings in this area have decreased in recent years, reflecting improved practices.

*The number of RBOs and CBOs in less-than-satisfactory condition has declined.*

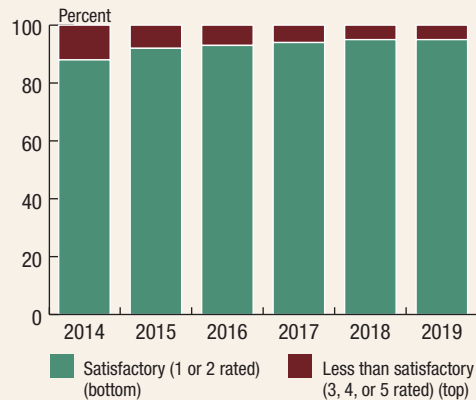
Supervisory ratings reflect the generally stable or improving condition of RBOs and CBOs. Less than 5 percent of firms are rated less than satisfactory, down from 12 percent in 2014 (figure 18).

**Figure 17. Common equity tier 1 ratio for RBO and CBO firms**



Note: Common equity tier 1 ratio is the ratio of tier 1 common equity to risk-weighted assets.  
Source: Call Report and FR Y-9C.

**Figure 18. Holding company ratings for firms < \$100 billion**



Source: Internal Federal Reserve supervisory databases. The 2019 value is as of the end of 2019:Q2.

*Supervisory findings continue to decline.*

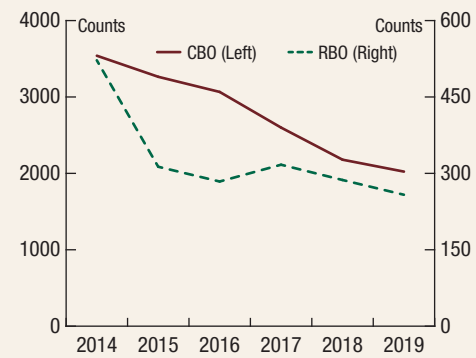
Outstanding supervisory findings continue to decline for both portfolios, as existing findings are closed and fewer findings are issued (figure 19). The average number of outstanding findings per institution has declined over the past five years for CBOs, from 0.8 to 0.5, and for RBOs, from nine to three. The most frequent categories for supervisory findings pertain to IT and operational risk for CBO firms, and risk management and internal controls for RBO firms.

**Supervision of Regional Banking Organizations**

*Most RBOs are in satisfactory condition.*

Most RBOs are in satisfactory condition with respect to asset quality, earnings, and liquidity. All RBOs currently reporting capital ratios meet the “well-capitalized” designation under interagency capital guidelines. However, a recent increase in capital redemptions across the portfolio has slightly reduced the aggregate level of common equity. Though some increase in liquidity, credit, and operational risks has been noted, most risk categories appear relatively stable.

**Figure 19. Outstanding supervisory findings for smaller institutions**



Note: Values prior to 2019 are as of year-end. The 2019 value is as of the end of 2019:Q2. The MRA/MRIA count data are subject to revisions as issues are reviewed, updated, and finalized; this could result in minor historical count fluctuations.  
Source: Internal Federal Reserve supervisory databases.

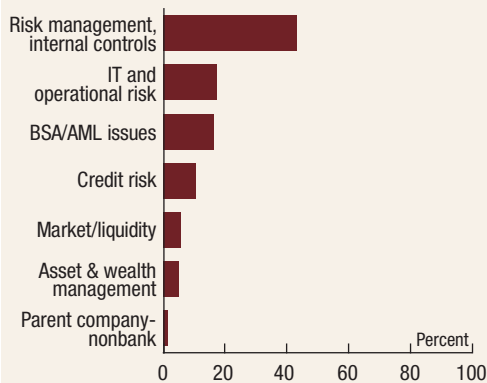


*Recent areas of supervisory focus include mergers and acquisitions risks, information technology/cybersecurity, and operational risks.*

The number and size of organizations in the RBO portfolio have grown recently as a result of mergers and acquisitions (see [box 10](#)). Such activity may heighten operational risks, as companies seek to integrate data and IT systems and consolidate operations.

In addition to operational risks from merger activities, other IT and operational concerns exist. Cybersecurity remains a key supervisory concern for RBOs as in other portfolios.

**Figure 20. Outstanding supervisory findings by category, RBO firms**



Note: As of 2019:Q2, there were 258 total outstanding supervisory findings for RBO firms.

Source: Internal Federal Reserve supervisory databases.

Federal Reserve staff continue to identify opportunities for RBOs to improve corporate governance practices and IT risk management.

*Risk management and internal controls at RBOs remain the top area for supervisory focus.*

Similar to previous years, the most prominent category of supervisory findings pertains to risk management and internal controls, followed by IT and operational risk, and BSA/AML ([figure 20](#)). Notwithstanding an increase in the total number of RBOs, the total number of outstanding MRAs has decreased ([figure 19](#)).

*Opportunities for improvements in credit underwriting practices have been identified.*

In 2019, Federal Reserve staff conducted an offsite analysis and comparison of commercial credit underwriting practices at certain RBO SMBs. Similar to the prior year, results indicate that a majority of loans included acceptable structures, terms, and adequate credit analysis. However, a number of firm-specific weaknesses were identified related to policy exceptions, financial covenants, financial analysis, guarantor support, and liberal credit structures. Results also highlighted “risk layering,” where more liberally underwritten credits had several areas of weakness.

[Box 9](#) details the list of upcoming RBO supervisory priorities.

### Box 9. Upcoming RBO Supervisory Priorities

#### Credit Risk

- concentrations of credit
  - commercial real estate
  - construction and land development
- commercial and industrial credits with high levels of leverage

#### Operational Risk

- merger and acquisition risks
- information technology and cybersecurity

#### Other

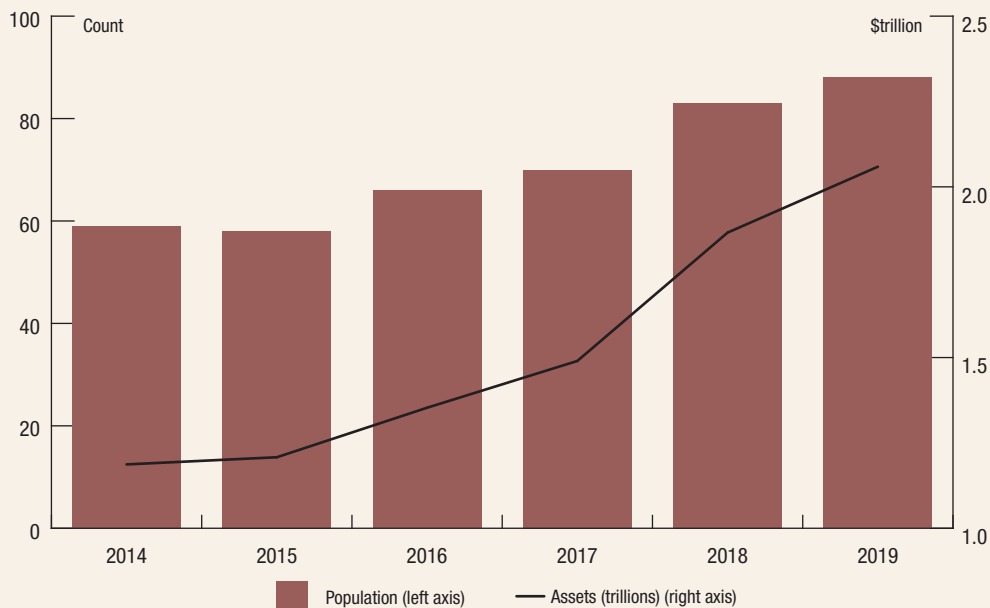
- BSA/AML
- understanding transition risk and plans for LIBOR
- monitoring the implementation process for CECL



### Box 10. Growth in the RBO Portfolio

Over the past five years, the number of RBOs has increased from 59 firms and roughly \$1.2 trillion in total assets in 2014 to 88 firms and about \$2.1 trillion in total assets as of June 30, 2019 (figure A).<sup>1</sup>

Figure A. RBO population and asset growth



Note: The chart depicts the total number of institutions supervised within the RBO portfolio as of each year end, or as of Q2 for 2019. For 2018 and 2019, the RBO population generally includes institutions between \$10 billion and \$100 billion. Prior to 2018, the RBO population generally included institutions between \$10 billion and \$50 billion.

Source: FR Y-9C and Internal Federal Reserve supervisory databases.

New entrants have primarily been the result of mergers or acquisitions. A small number of firms transitioned from the LFBO portfolio into the RBO portfolio following the implementation of an EGRRCPA provision that raised the lower bound of the asset threshold for certain enhanced prudential standards from \$50 billion to \$100 billion.

Federal Reserve staff strive to ensure that entrants to the portfolio understand applicable regulations and relevant guidance and have policies that are commensurate with their increased size and complexity.

<sup>1</sup> For purposes of this section, SLHCs that are RBO-sized and primarily engaged in insurance and commercial activities are excluded.

### Box 11: The Community Bank Leverage Ratio

On October 29, 2019, the OCC, the FDIC and the Federal Reserve Board finalized the community bank leverage ratio (CBLR) rule that simplifies capital requirements for community banks by allowing them to adopt a simple leverage ratio to measure capital adequacy. The CBLR framework removes requirements for calculating and reporting risk-based capital ratios for a qualifying community bank that opts into the framework.

To qualify for the framework, a community bank must have less than \$10 billion in total consolidated assets, limited amounts of off-balance-sheet exposures and trading assets and liabilities, and a leverage ratio greater than 9 percent.

In response to comments, several changes were made to reduce compliance burden. In particular, components to measure the leverage ratio were modified for simplicity and a grace period was introduced. If a firm falls below the leverage ratio requirement, it will have a two-quarter grace period to increase its capitalization.

The agencies estimate approximately 85 percent of community banks will qualify for the CBLR framework. The final rule is consistent with EGRRCPA.

The CBLR framework will first be available for banking organizations to use in their March 31, 2020, Call Report or Form FR Y-9C, as applicable.

### Supervision of Community Banking Organizations

*The financial condition of CBOs is robust.*

Capital levels at CBOs have remained high over the past five years. Aggregate capital, earnings, and asset quality are sound. Common equity tier 1 ratios average nearly 14 percent, a five-year high. Similar to the RBO portfolio, there has been a slight uptick in liquidity risk associated with this portfolio, though it is still low-to-moderate at the majority of CBO firms. The overall risk level in the portfolio continues to decline.

*Consolidation continues to reduce the number of community banks.*

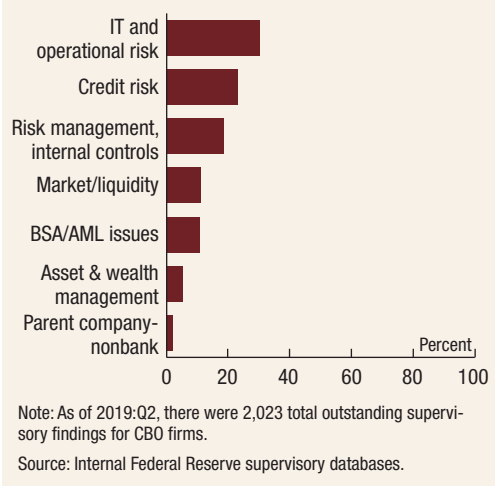
Bank consolidation has continued, resulting in a steady decline in the number of community banks over the past five years. Charter conversions have played a more subdued role in the decline in community SMBs. Over the past five years, there has been no SMB *de novo* activity in the portfolio, and there have been no SMB failures since 2017. As of June 2019, the Federal Reserve supervised 719 CBO SMBs as compared with 742 SMBs in June 2018. This decline is roughly in line with trends from recent years.

*For CBOs, the number of outstanding findings has declined over the past five years.*

During 2018, the Federal Reserve completed examinations at over 200 CBO SMBs and conducted 2,840 holding company inspections.<sup>9</sup> The volume of outstanding supervisory findings at CBOs has steadily declined over the past five years (figure 19), as has the number

<sup>9</sup> For noncomplex holding companies with less than \$3 billion in assets (referred to as “small shell holding companies”) the Federal Reserve uses an offsite inspection program that relies substantially on the work performed by the insured depository institution regulator. There has been a year-over-year reduction in the number of CBO SMB exams because of the implementation of the expanded exam cycle for certain banks. To be eligible, SMBs under \$3 billion in total assets must be well-capitalized, have a satisfactory management and CAMELS composite rating, not under formal enforcement action, and must not have been acquired within the previous year. Currently, around 90 percent of all CBO SMBs may be eligible for the expanded 18-month exam cycle.

**Figure 21. Outstanding supervisory findings by category, CBO firms**



**Box 12. CBO Supervisory Priorities**

- Credit Risk**
- concentrations of credit
    - commercial real estate lending
    - agricultural lending
  - loan underwriting and credit administration
- Operational Risk**
- information technology and cybersecurity
  - fintech
- Other**
- BSA/AML
  - liquidity risk
  - understanding transition risk and implementation plans for LIBOR and CECL

of firms under enforcement actions. Over the past year, there has been a net decrease in outstanding IT and operational risk supervisory findings, indicating continued progress. That said, IT and operational risk continues to hold the largest share of outstanding supervisory findings (figure 21).

Box 12 details the focus of this upcoming year’s CBO supervisory priorities.



# Appendix A: Data

## Definition of Data Sources

The Supervision and Regulation Report includes data on institutions supervised or not supervised by the Federal Reserve System. This appendix details these sources. All data presented in this report are as of June 30, 2019, unless specified otherwise.

### **FFIEC Call Reports**

The FFIEC Consolidated Reports of Condition and Income, also known as the Call Report, is a periodic report that is required to be completed by every national bank, state member bank, insured nonmember bank, and savings association as of the last day of each calendar quarter. The details required to be reported depend on the size of the institution, the nature of the institution's activities, and whether or not it has foreign offices. Call Report data are a widely used source of timely and accurate financial data regarding a bank's financial condition and the results of its operations. The data collected from the Call Report are used to monitor the condition, performance, and risk profiles of the institutions as individuals and as an industry.

### **FR Y-9C**

The Consolidated Financial Statement for Holding Companies, also known as the FR Y-9C report, collects basic financial data from domestic BHCs, SLHCs, U.S. IHCs, and securities holding companies (SHCs). Respondent burden reduction initiatives led to the asset-sized threshold change from \$500 million to \$1 billion, and from \$1 billion to \$3 billion effective March 2015 and September 2018, respectively. In addition, BHCs, SLHCs, IHCs, and SHCs meeting certain criteria may be required to file this report, regardless of size. However, when such BHCs, SLHCs, IHCs, or SHCs own or control, or are owned or controlled by, other BHCs, SLHCs, IHCs, or SHCs, only top-tier holding companies must file this report for the consolidated holding company organization. The information contained in the report is as of the last day of each calendar quarter.

## Notes on Specific Data

### **Top Holder**

All data, unless otherwise noted, use top-holder data. This population comprises top-tier Call Report filers and top-tier Y-9C filers. In instances where a top-tier holding company does not file the Y-9C, we combine financial data of subsidiary banks or savings associations to approximate the consolidated financial data of the holding company.

### **Savings and Loan Holding Companies (SLHCs)**

Supervisory and regulatory responsibilities for SLHCs were transferred to the Federal Reserve in 2011. Most SLHCs migrated to the Federal Reserve's standardized report forms for holding companies in 2012, with the exception of certain SLHCs engaged primarily in insurance and commercial activities, which continued to submit a tailored report form. In this report, SLHCs that are depository in nature are included in the portfolio that corresponds with their relative size, while SLHCs that are primarily engaged in insurance and commercial

activities are considered their own portfolio. Unless otherwise noted, the data presented exclude insurance and commercial SLHCs.

### **Commercial Real Estate Loans**

The sum of construction, land development, and other land loans; loans secured by farmland; loans secured by multifamily residential properties; and loans secured by nonfarm non-residential properties.

### **Consumer Loans**

Consumer loans include credit cards, other revolving credit lines, automobile loans, and other consumer loans (includes single payment and installment loans other than automobile loans, and all student loans).

### **Nonperforming Loans**

Nonperforming loans, or problem loans, are those loans that are 90 days or more past due, plus loans in nonaccrual status.

### **Common Equity Tier 1**

The Federal Reserve's evaluation of a firm's common equity capital was initially measured using a tier 1 common capital ratio but now is evaluated using a common equity tier 1 (CET1) capital ratio, which was introduced into the regulatory capital framework with the implementation of Basel III. From 2006 through 2013, tier 1 common was used to measure common equity capital for all firms. In 2014, both tier 1 common capital (for non-advanced approaches firms) and common equity tier 1 capital (for advanced approaches firms) were used. From 2015 to present, common equity tier 1 capital has been used for all firms.

Common equity tier 1 capital ratio is defined as common equity tier 1 capital as a percent of risk-weighted assets. Advanced approaches institutions are required to report risk-weighted assets using an internal model-based approach and a standardized approach. We take the higher value of the two risk-weighted assets calculations, per requirements under the Collins Amendment.

### **Reserve Coverage Ratio**

The reserve coverage ratio is the ratio of ALLL over nonperforming loans. When calculating nonperforming loans for the reserve coverage ratio, rebooked Ginnie Mae loans that have been repurchased or are eligible for repurchase have been removed.

### **Credit Default Swap (CDS) Spread**

The five-year CDS spread is the premium payment expressed as a proportion of the notional value of the debt which is being insured against default (typically \$10 million in senior debt) in basis points. Data are based on daily polls of individual broker-dealers worldwide. Note that these broker quotes are typically not transaction prices. Data provided are for LISCC (domestic and foreign) firms only.

### **Market Leverage**

The market leverage ratio—defined as the ratio of the firm's market capitalization to the sum of market capitalization and the book value of liabilities—can be considered a market-based

measure of firm capital (expressed in percentage points). Data provided are for LISCC (domestic and foreign) firms only.

### **CAMELS Ratings**

Following an examination of a commercial bank, the examiner's conclusions regarding the overall condition of the bank are summarized in a composite rating assigned in accordance with guidelines provided under the Uniform Financial Institution Rating system (CAMELS). The composite rating represents an overall appraisal of six key assessment areas (components) covered under the CAMELS rating system: Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk.

In addition, and separate from the interagency Uniform Financial Institutions Rating System, the Federal Reserve assigns a risk-management rating to all SMBs. The summary, or composite, rating, as well as each of the assessment areas, including risk management, is delineated on a numerical scale of 1 to 5, with 1 being the highest or best possible rating. Thus, a bank with a composite rating of 1 requires the lowest level of supervisory attention, while a 5-rated bank has the most critically deficient level of performance and therefore requires the highest degree of supervisory attention.

When appraising the six key assessment areas and assigning a composite rating, the examiner weighs and evaluates all relevant factors for downgrades and upgrades of supervisory ratings.

### **Liquid Assets**

Liquid assets are reserves plus estimates of securities that qualify as high-quality liquid assets as defined by the liquidity coverage ratio requirement.

### **Matters Requiring Attention (MRAs)/Matters Requiring Immediate Attention (MRIAs)**

MRAs constitute matters that are important and that the Federal Reserve is expecting a banking organization to address over a reasonable period of time but when the timing need not be "immediate."

MRIAs are matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately.

The MRA/MRIA count data are subject to revisions as issues are reviewed, updated, and finalized; this could result in minor historical count fluctuations.





## Appendix B: Abbreviations

ALLL	allowance for loan and lease losses
AML	anti-money laundering
BHC	bank holding company
BSA	Bank Secrecy Act
C&I	commercial and industrial
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity
CBLR	community bank leverage ratio
CBO	community banking organization
CCAR	Comprehensive Capital Analysis and Review
CDS	credit default swap
CECL	current expected credit loss
CET1	common equity tier 1
CRE	commercial real estate
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
EGRRCPA	Economic Growth, Regulatory Relief, and Consumer Protection Act
FBO	foreign banking organization
FDIC	Federal Deposit Insurance Corporation
IHC	intermediate holding company
IT	information technology
LBO	large banking organization
LFBO	large and foreign banking organization
LIBOR	London Interbank Offered Rate
LISCC	Large Institution Supervision Coordinating Committee
MRA	matter requiring attention
MRIA	matter requiring immediate attention
OCC	Office of the Comptroller of the Currency
OFAC	Office of Foreign Asset Control
RBO	regional banking organization
ROAA	return on average assets
ROE	return on equity
SCAP	Supervisory Capital Assessment Program

SHC	securities holding company
SLHC	savings and loan holding company
SMB	state member bank
SNC	Shared National Credit



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