BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF
SUPERVISION AND REGULATION

June 7, 2024

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Re: [ ] – *Final Review of Appeal of Material Supervisory Determination in Report of Holding Company Inspection*

Dear [ ]:

This letter addresses your April 17, 2024, request for final review of a material supervisory determination submitted on behalf of [a Bank Holding Company] ("[BHC]"), appealing a decision of the Federal Reserve Bank [ ] ("Reserve Bank") to assign [the BHC] a liquidity subcomponent rating of [ ]. Specifically, [the BHC] objects to the Reserve Bank examiners' judgment in assigning it [ ] during a period of market and banking stress, rather than adopting the ratings assigned to its [ ] subsidiary banks by other banking regulators.

The Bank Holding Company Act (the "BHCA") authorizes the Federal Reserve to examine a bank holding company to assess its financial condition, including its liquidity levels and access to funding; to evaluate its financial, operational, and other risks; and to examine its systems for monitoring and controlling those risks.[1] The BHCA further provides that the Federal Reserve must, to the fullest extent possible, rely upon the examination reports issued by the banking regulators of the holding company's subsidiary banks, to avoid the duplication of examination activities. Importantly, the BHCA does not require examiners to invariably adopt ratings for a bank holding company identical to the ratings assigned to its subsidiary banks. As the only federal regulator with an overarching view of a banking organization's activities, the Federal Reserve is uniquely positioned to assign ratings based on a consolidated assessment of the organization, and the examiners' judgment may depart from the judgment of the

[1] Bank Holding Company Act of 1956, 12 U.S.C. § 1841 et seq. (2018).

primary regulator in certain circumstances, including (but not limited to) where a bank holding company owns multiple subsidiary banks or other financial entities, where a subsidiary bank's ratings are based on data that may not be timely or current, or where financial market conditions warrant such a departure.

In this matter, the initial panel reviewing this appeal agreed with the Reserve Bank's liquidity subcomponent rating of [ ] after thorough consideration of [the BHC's] arguments and relevant supervisory record. Following our review of the supervisory record, the arguments presented by [the BHC] in this appeal, and consideration of the applicable law, regulations, and policy, we find the initial panel's decision and the assigned liquidity subcomponent rating to be reasonable, and therefore affirm the initial panel's decision, as more fully explained below.

Background

From [ ], the Federal Reserve Bank [ ] conducted a holding company inspection of [the BHC]. [The BHC] is a [ ] bank holding company with [ ] in consolidated assets. Most of [the BHC's] financial activity is conducted through [ ] subsidiary banks.[2] The substantial majority of [the BHC's] financial activity occurs at [ ]. Although [the BHC] inspection originally contemplated evaluating financial data as of March 31, 2023, the examination also included updated financial information as of June 30, 2023, due to the significant ongoing market events impacting the [ ] banking sector that began in March 2023 (the "2023 liquidity stress event").[3]

On [ ], the Reserve Bank issued a Report of Holding Company Inspection for [the BHC] ("Inspection Report"). [The BHC] is evaluated under the Federal Reserve's RFI/C(D) Rating System ("RFI rating system"), which assesses certain risk management and financial condition factors that are common to holding companies.[4] The RFI rating system assigns a bank holding company a rating of 1 to 5 (strongest to weakest) over five main components[5] and eight subcomponents.[6] In the Inspection Report, the Reserve Bank assigned [the BHC] [ ]. The Reserve Bank, however,

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[2] [ ].

[3] *See* Michael S. Barr, Vice Chair for Supervision, Board of Governors of the Federal Reserve System, *On Building a Resilient Regulatory Framework* (May 20, 2024) (describing the 2023 liquidity stress event), *available at* https://www.federalreserve.gov/newsevents/speech/barr20240520a.htm; *Oversight of Prudential Regulators: Hearing Before the H. Fin. Servs. Comm.*, 118th Cong. (2023) (statement of Michael S. Barr, Vice Chair for Supervision, Board of Governors of the Federal Reserve System) (describing lessons learned from the 2023 liquidity stress event), *available at* https://www.federalreserve.gov/newsevents/testimony/barr20230516a.htm.

[4] Board of Governors of the Federal Reserve System, SR 19-4, *Supervisory Rating System for Holding Companies with Total Consolidated Assets Less than $100 Billion* (Feb. 26, 2019).

[5] The components of the RFI rating system are risk management (R), financial condition (F), impact of nondepository institutions on subsidiary depository institutions (I), composite assessments (C), and depository institutions (D).

[6] The risk management component is supported by individual subcomponent ratings for board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems; and internal controls. The financial condition rating is supported by individual subcomponent ratings for capital, asset quality, earnings, and liquidity.

downgraded the liquidity subcomponent of [the BHC's] Financial Condition rating [ ] —the material supervisory determination that is the subject of this review.[7]

The Inspection Report explained that [the BHC's] consolidated liquidity was "satisfactory and adequate to support current and anticipated liquidity needs" but noted conditions that could pose increased risks to liquidity in light of the ongoing market conditions and the 2023 liquidity stress event.[8] The Inspection Report noted a decline in total deposits due to tapering of customer surge deposits, heightened market competition for core deposits, and the adverse impact of the 2023 liquidity stress event on [ ] banking organizations.[9] This resulted in [the BHC's] balance sheet contracting and posting negative growth of [ ] over the first six months of 2023.[10] The Inspection Report cited unfavorable trends in liquidity metrics such as the liquid-asset buffer, loan-to-deposit ratio, and net non-core dependency ratio.[11] It further noted that deposit runoff remained constant and deposit balances continued to decline in 2023.[12] Uninsured deposits were elevated, comprising [ ] of deposits, with cash balances providing approximately [ ] coverage of uninsured deposits.[13] In addition, liquidity options from unpledged securities were adversely impacted by [the BHC's] ongoing unrealized loss position ([ ]) which led the Reserve Bank to conclude that funding liquidity needs beyond the projected short-term cash position could require borrowing on existing lines at significantly higher interest rates.[14]

<u>Procedural History</u>

[The BHC] timely appealed this material supervisory determination on January 5, 2024.[15] In its appeal, [the BHC] advanced two arguments as to why the Reserve Bank erred in downgrading [the BHC's] liquidity subcomponent rating [ ]. First, [the BHC] argued that Federal Reserve supervisory guidance required the Reserve Bank to rely on [the BHC's] subsidiary bank ratings, and that the Reserve Bank failed to adhere to these guidelines by departing from the subsidiary banks' ratings.[16] Second, [the BHC]

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[7] Inspection Report [ ] at 7-8.

[8] *Id.* at 7

[9] *Id.*

[10] *Id.* at 8

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] [The BHC], Appeal of [ ], Report of Inspection Liquidity Rating ("Initial Appeal") (Jan. 5, 2024).

[16] *See id.* at 5-10.

argued that the Inspection Report's liquidity analysis failed to assess available data that showed that [the BHC's] liquidity was strong.[17]

In accordance with the Federal Reserve Board's Internal Appeal Process for Material Supervisory Determinations,[18] the Board's Director of Supervision and Regulation appointed an initial review panel comprised of independent members from other Reserve Banks to review the material supervisory determination on a *de novo* basis. On March 19, 2024, the initial panel affirmed the Reserve Bank's downgrade of [the BHC's] liquidity subcomponent rating [ ].[19] [The BHC] timely filed a request for final review on April 17, 2024.[20]

Analysis

The authority to decide [the BHC's] appeal of the initial panel's decision is committed to the final review panel.[21] Unlike the initial panel's *de novo* review of the supervisory determination, the final review panel only determines "whether the decision of the initial review panel is reasonable." In making this determination, the final review panel considers "whether the decision was based on a consideration of the applicable law, regulations, and policy, and whether there has been a clear error of judgment." The final review panel may affirm the initial panel's decision "even if it is possible to draw a contrary conclusion from the record presented on appeal."

After consideration of the record, applicable law, regulations, and policy, we find that the decision of the initial panel was reasonable, and that [the BHC's] liquidity subcomponent rating of [ ] does not reflect a clear error of judgment, especially considering financial and market conditions at the time the rating was issued.

[The BHC] argues that the Reserve Bank departed from examination guidelines by not basing [the BHC's] liquidity subcomponent rating on the ratings of its subsidiary banks, all of which were assigned [ ] liquidity ratings in their most recent examinations. The record shows, however, that the Reserve Bank did consider the subsidiary bank ratings and followed applicable examination guidelines. Under the BHCA, the Reserve Bank is required "to the fullest extent possible, [to] rely on . . . examination reports made by other Federal or State regulatory agencies relating to a bank holding company and any subsidiary of a bank holding company," such as the reports of insured depository institution ("IDI") regulators, to avoid duplication of examination activities, reporting requirements, and requests for information.[22] The BHCA does not

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[17] *See id.* at 11-22.

[18] *See* Board of Governors of the Federal Reserve System, *Internal Appeals Process for Material Supervisory Determinations*, 85 Fed. Reg. 15175 (Mar. 17, 2020); Board of Governors of the Federal Reserve System, SR 20-28, *Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System* (Dec. 4, 2020).

[19] *See* Letter from [ ] to [the BHC] re: [The BHC] Initial Appeal of Material Supervisory Determination ("Initial Panel Decision") (Mar. 19, 2024).

[20] *See* [The BHC], Petition for Final Review of Appeal of Material Supervisory Determination in Report of Holding Company Inspection ("Final Review Petition") (Apr. 17, 2024).

[21] *See Internal Appeals Process for Material Supervisory Determinations*, 85 Fed. Reg. at 15181; SR 20-28 at 7.

[22] 12 U.S.C. § 1844(c).

require the Reserve Bank to invariably adopt the ratings of IDI regulators.[23] The Reserve Bank should review available examination reports and rely on the information therein "to the fullest extent possible" when making its own judgement as to an appropriate rating. For example, applicable supervisory guidance contemplates that the Federal Reserve should decide if conclusions made by an IDI regulator "remain a valid basis for assigning the supervisory ratings to the consolidated holding company" in various scenarios, including when the "holding company has deteriorating financial or risk trends that are not reflected in the most current IDI regulators' examination reports."[24]

The Inspection Report indicates that the Reserve Bank staff reviewed the supervisory products prepared by the IDI regulators and relied upon them in assessing the condition of the holding company.[25] The initial panel also found that the Reserve Bank relied on the IDI examinations, but noted that the Reserve Bank's reliance was necessarily limited by the fact that [ ] subsidiary examinations contained financial data that did not fully account for the 2023 liquidity stress event.[26] An additional examination, involving one of [the BHC's] largest subsidiaries, was not issued until after the Inspection Report.[27] Thus, the Reserve Bank did not have examination reports with timely financial data for [ ] subsidiaries when issuing the Inspection Report.[28] The initial panel found that the Reserve Bank gave due consideration to the IDI reports, but had to consider those in the context of material changes occurring in the subsidiary banks' liquid assets and deposit levels that post-dated the reports, along with the volatility in the banking industry at the time.[29] Significantly, the Reserve Bank assigned ratings consistent with the IDI report ratings with the exception of the liquidity subcomponent, which was most impacted by the ongoing liquidity uncertainty at the time the Inspection Report was issued. For these reasons, we find that the decision of the initial panel concluding that the Reserve Bank did not deviate from supervisory guidance when

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[23] 12 U.S.C. § 1844(c)(2)(B) (provision entitled "Use of reports *to reduce examinations*" (emphasis added)), 1844(c)(2)(C); *see* Board of Governors of the Federal Reserve System, Bank Holding Company Supervision Manual ("BHC Manual") §§ 1040.0.3.1 & 1050.2.5 (Feb. 2023); *see also* BHC Manual § 1050.2.1.1.

[24] Board of Governors of the Federal Reserve System, SR 16-4, *Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $100 Billion*, at 4 (Feb. 17, 2021); BHC Manual § 1050.2.5.1.

[25] Inspection Report at 3.

[26] These [ ] subsidiaries are [ ]. [The BHC's] argument that the subsidiary "bank examinations were concluded after the liquidity stress event" places undue focus on the IDI report issuance dates rather than the timeframes of the financial data in the reports. While the [ ] report does mention data points as of the end of March 2023, there is no indication that the report comprehensively analyzes [ ] liquidity in light of the 2023 liquidity stress event, which continued well past March 2023.

[27] The [ ] exam was issued on [ ].

[28] A report for [ ], only analyzed information through March 31, 2022. *See also* BHC Manual § 1050.2.1.1 ("The nature and scope of independent Federal Reserve supervisory work required to develop and maintain an understanding and assessment of a regional HC depend largely on the extent to which other relevant primary supervisors or functional regulators have information or assessments upon which the Federal Reserve can draw.").

[29] *See* BHC Manual § 4066.0.1.

downgrading [the BHC's] liquidity subcomponent was reasonable and not a clear error in judgment.

[The BHC] also disputes the [ ] liquidity subcomponent rating on the basis that that the Inspection Report ignored available data showing that [the BHC's] liquidity was strong. Under the RFI rating system, the liquidity subcomponent "reflects the consolidated organization's ability to attract and maintain the sources of funds necessary to support its operations and meet its obligations. The funding conditions for each of the material legal entities in the holding company structure should be evaluated to determine if any weaknesses exist that could affect the funding profile of the consolidated organization."[30] [ ].[31] [ ].[32] When determining appropriate RFI ratings, examiners exercise their overall judgment of the company, relying on examination results, supervisory findings, and other information, such as market conditions.[33]

During the relevant time period for the Inspection Report, [the BHC] was experiencing core deposit outflows, an increase in non-core funding, elevated uninsured deposits, and decreased liquidity reserves.[34] From year-end 2022 through the second quarter of 2023, [the BHC] experienced declining core deposits and total deposits. [The BHC's] reliance on noncore funding also increased in this period. While [the BHC] maintains that deposit runoffs were expected by management, the Reserve Bank also found that the liquid assets that [the BHC] management had put into place to counter deposit outflows had significantly decreased. From June 30, 2022 to June 30, 2023, [the BHC's] liquidity reserve of interest-bearing bank balances ("IBBB") and short term investments had declined from [ ].[35] [The BHC] contends that management's strategy "positively affected the Company's liquidity because the remaining deposit base had a lower risk of outflow," but, as the initial panel noted, the deposit runoff remained relatively constant in 2023 with deposit balances declining and additional runoff reported by [the BHC] through August.[36]

At the time of the Inspection Report, [the BHC's] uninsured deposits accounted for [ ] of [the BHC's] deposit base as of June 30, 2023. The 2023 liquidity stress event in the [ ] banking sector highlighted how uninsured deposits are more prone to runs, in part because they lack a specific government guarantee.[37] Another source of potential liquidity—[the BHC's] securities portfolio—had been in an unrealized loss

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[30] SR 19-4 at 4.

[31] [ ].

[32] [ ].

[33] *See* Board of Governors of the Federal Reserve System, "Understanding Federal Reserve Supervision: How Federal Reserve Supervisors Do Their Jobs," https://www.federalreserve.gov/supervisionreg/how-federal-reserve-supervisors-do-their-jobs.htm (last visited June 6, 2024).

[34] These changes left [the BHC] at or below peer level for certain key liquidity metrics.

[35] Initial Panel Decision at 5. [The BHC] dismisses the reduction in liquid assets as not being cited in the Inspection Report, but the report notes decreases in [the BHC's] interest bearing bank balances. Even if the Inspection Report did not clearly convey the reduction in liquid assets, the initial panel conducts a *de novo* review based on the record available to and relied upon by the Reserve Bank.

[36] *Compare* Final Review Petition at 4, *with* Initial Panel Decision at 2-3.

[37] Board of Governors of the Federal Reserve System, Financial Stability Report at 49 (May 2023), *available at* https://www.federalreserve.gov/publications/files/financial-stability-report-20230508.pdf.

position for a year, which could have affected the ability of [the BHC] to liquidate these securities without a financial consequence if needed.[38] As the initial panel noted, the level of unrealized loss in this portfolio had the potential to limit [the BHC's] access to funding on favorable terms.[39] To account for these factors, the Reserve Bank downgraded the liquidity subcomponent rating from [ ] which, as explained above, was the most affected by the negative trends and uncertainties at the time the Inspection Report was issued. [ ].

[The BHC] argues that the initial panel's focus on general economic conditions indicates that the liquidity subcomponent was a pre-determined result. It is clear, however, that the Inspection Report and the initial panel assessed the specific conditions of [the BHC] in the context of the banking environment at the time of the 2023 liquidity stress event. The fact that the Reserve Bank reviewed [the BHC's] deposit outflows, declining liquidity, increased non-core funding, level of uninsured deposits and unrealized losses in the context of the 2023 liquidity stress event, which affected ongoing economic trends and market conditions, was not only appropriate but necessary. As noted in the BHC Manual, "[c]hanges in economic conditions or exposure to credit, market, operation, legal, and reputation risks also can affect an institution's liquidity risk profile and should be considered in the assessment of liquidity and asset/liability management."[40] The Reserve Bank could not fulfill its supervisory responsibilities by largely disregarding a liquidity stress event of the magnitude that occurred in 2023 when assigning a liquidity subcomponent rating. The totality of these factors led the Reserve Bank to conclude that [the BHC's] liquidity subcomponent was [ ], which was a reasonable outcome given the environment and the facts known to the Reserve Bank at the time.

For the foregoing reasons, the final review panel, having considered the record, the arguments presented by [the BHC], and applicable law, regulations, and policy, affirms the initial panel's determinations.

Sincerely,

[ ]
Chair, Final Review Panel

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[38] [The BHC] argues that the Inspection Report erred by calculating the unrealized losses impact on [the BHC's] capital pre-tax instead of using Accumulated Other Comprehensive Income ("AOCI"). Final Review Petition at 5. Although AOCI figures reduce the ratio of unrealized losses to tier 1 capital from [ ], such losses are still significant. Initial Appeal at 17.

[39] [The BHC] argues that the Federal Reserve's Bank Term Funding Program (BTFP), an emergency lending facility established to provide access to liquidity in response to the 2023 liquidity stress event, was an additional source of funding for [the BHC]. But the BTFP was a temporary facility that expired on March 11, 2024.

[40] BHC Manual § 4066.0.1.

Cc: [ ]
Final Review Panel Member

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Final Review Panel Member

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