

Summary of Final Review of [] MSD Appeal

A financial holding company (“FHC”) supervised by the Board of Governors of the Federal Reserve System (the “Board”) appealed under the Board’s internal appeals procedures¹ the following material supervisory determinations made by a Federal Reserve Bank (“Reserve Bank”):

1. the FHC’s risk management rating (including its subcomponents);
2. the FHC’s composite rating;
3. a Matter Requiring Attention (“MRA”) regarding the FHC’s internal audit; and
4. a MRA regarding the FHC’s Risk Appetite Statement (“RAS”).

The initial panel reviewing the appeal agreed with the Reserve Bank’s material supervisory determinations, whereupon the FHC sought final review. What follows is a summary of the final review panel’s decision, which found the initial review panel’s decision to be reasonable and upheld the Reserve Bank’s material supervisory determinations.²

The FHC derives most of its total revenue from a subsidiary bank (“Subsidiary Bank”) supervised by another federal banking regulator (“Primary Federal Regulator”); it also has nonbank subsidiaries supervised by another regulatory agency (“Agency A”). In 2024, the Reserve Bank conducted a holding company inspection and identified deficiencies in the FHC’s internal audit, RAS, and regulatory reporting and assigned the FHC supervisory ratings under the Board’s RFI/C(D) Rating System, which assesses certain risk management and financial condition factors for bank holding companies.³ The Reserve Bank downgraded the FHC’s risk management rating (including four of its subcomponent ratings) as well as its composite rating and issued three MRAs to the firm.

1. The final review panel found that the Reserve Bank’s ratings downgrade in risk management appropriately relied upon supervisory findings prepared by the Primary Federal Regulator and Agency A. During the 2023-24 examination cycle, the Primary Federal Regulator had conducted ten targeted examinations that included nineteen new findings related to commercial credit, capital markets, and governance. These findings, among several other deficiencies, included downgrades of certain loans identified by the Primary Federal Regulator as well as regulatory reporting violations related to some of those loans. Likewise, Agency A determined that the subsidiaries of the FHC that Agency A regulates violated certain laws and regulations, including the Bank Secrecy Act and anti-money laundering (“BSA/AML”) rules, some of which violations Agency A referred to its enforcement department. In response to most of these findings, the FHC either did not contest them or informed Agency A that it had made

¹ 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).

² This appeal was decided in accordance with the supervisory policies and principles applicable during the period the material supervisory determinations were issued.

³ 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*, at 1 (Feb. 26, 2019).

reasonable steps to correct its noncompliance. The initial panel found, and the final panel agreed, that the Reserve Bank issued the ratings downgrade consistent with the Bank Holding Company Act (“BHCA”) provision stating that the Board must, to the fullest extent possible, rely upon the findings of the banking regulators of the holding company’s subsidiary banks.⁴

2. The final panel also agreed that the initial panel did not err in upholding the Reserve Bank’s downgrade of the FHC’s composite rating. In contrast to its appeal of the risk management rating, the FHC contended that the Reserve Bank should have adhered to the Primary Federal Regulator’s composite rating of the Subsidiary Bank, which was left unchanged in the 2023-24 examination cycle, especially in light of the aforementioned provision in the BHCA requiring reliance on the Primary Federal Regulator’s views. The final panel explained, however, that the BHCA does not require examiners to invariably adopt ratings for a financial holding company identical to the ratings assigned to its subsidiary bank and noted that the Subsidiary Bank’s asset quality rating had been downgraded by the Primary Federal Regulator, even though the composite rating had not. As the only federal regulator with a consolidated view of a banking organization’s activities, the Board is uniquely positioned to assign ratings based on the assessment of the entire organization, and may depart from the primary regulator in certain circumstances, including (but not limited to) where a bank holding company owns multiple subsidiary banks or other nonbank subsidiaries with significant deficiencies or risks; and here, the Reserve Bank observed material deficiencies in internal audit and internal controls related to the FHC’s nonbank subsidiaries that the Primary Federal Regulator did not consider. Based on these factors, the final panel found that the Reserve Bank’s departure from the Primary Federal Regulator’s composite rating was reasonable.

3. With respect to the MRA regarding the FHC’s internal audit, the final panel agreed with the FHC that the initial panel improperly assumed that a coverage gap in internal audit’s ability to identify risks and assess internal controls, which resulted in reporting violations, necessarily conveyed that internal audit was failing to review unidentified entities in the audit universe. Nevertheless, citing the Board’s supervisory guidance on the internal audit function, the final review panel found that the FHC’s audit methodology and plan were ineffective because they were designed in a manner that rendered it unlikely to “focus on the nature and extent of monitoring compliance with,” among other things, “established policies and processes and applicable laws and regulations.”⁵ Further, the coverage gap in the FHC’s audit methodology and plan was confirmed by Agency A’s findings related to the FHC nonbank subsidiaries’ noncompliance with certain laws and regulations, including BSA/AML regulations, and regulatory reporting requirements.

4. Regarding the MRA related to the FHC’s RAS, the final panel found reasonable the initial panel’s decision that the FHC’s qualitative risk appetite for total borrowings and brokered deposits was misaligned with the quantitative risk limits in the RAS. The final panel explained that the RAS is an important tool for an institution and its regulators to evaluate in order to align the institution’s evolving business strategies and activities with the institution’s risk appetite.

⁴ See 12 U.S.C. § 1844(c)(2).

⁵ Board of Governors of the Federal Reserve System, SR 13-1, *Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing*, at 3 (Jan. 23, 2013).

The RAS's low qualitative risk tolerance for lack of diversity in its funding sources did not align with the high quantitative risk limits the FHC set for total borrowings and brokered deposits. This was contrary to the FHC's own stated goal in the RAS to use the qualitative and quantitative risk appetite statements to align the FHC's risk appetite with risk tolerance. The final panel rejected the FHC's contention that the Reserve Bank did not review the full set of documents relevant to the RAS in making its MRA determination, since the documents identified did not contain a sufficient rationale to explain the RAS's low qualitative appetite statement and high quantitative risk limits. Similar deficiencies, moreover, were identified by the Subsidiary Bank's Primary Federal Regulator.