2100.0.1 FOREIGN OPERATIONS OF U.S. BANKING ORGANIZATIONS

U.S. banking organizations may conduct a wide range of overseas activities. The Federal Reserve has broad discretionary powers to regulate the foreign activities of member banks and bank holding companies (BHCs) so that, in financing U.S. trade and investments abroad, these U.S. banking organizations can be competitive with institutions of the host country without compromising the safety and soundness of their U.S. operations.

Some of the Federal Reserve's responsibilities over the international operations of member banks (national and state member banks) and BHCs include

- authorizing the establishment of foreign branches of national banks and state member banks and regulating the scope of their activities;
- chartering and regulating the activities of Edge Act and agreement corporations, which are specialized institutions used for international and foreign business;
- authorizing foreign investments of member banks, Edge Act and agreement corporations, and BHCs and regulating the activities of foreign firms acquired by such investors; and
- establishing supervisory policy and practices regarding foreign lending by state member banks.

The Federal Reserve examines the international operations of state member banks, Edge Act and agreement corporations, and BHCs principally at the U.S. head offices of these organizations. When appropriate, the Federal Reserve conducts examinations at the foreign operations of a U.S. banking organization in order to review the accuracy of financial and operational information maintained at the head office as well as to test the organization's adherence to safe and sound banking practices and to evaluate its efforts to implement corrective measures. Examinations abroad are conducted in cooperation with the responsible host-country supervisor.

2100.0.2 EDGE ACT AND AGREEMENT CORPORATIONS

Edge Act and agreement corporations are U.S. financial institutions that carry out international banking and financing operations, some of which the parent banks themselves are not permitted to undertake under existing laws. These corporations may act as holding companies, provide international banking services, and finance industrial and financial projects abroad, among other activities.

Sections 25 and 25A of the Federal Reserve Act grant Edge Act and agreement corporations authority to engage in international banking and foreign financial transactions. The Board's Regulation K (12 CFR 211.6) also outlines the permissible activities of Edge and agreement corporations in the United States. Among other activities, these corporations may (1) make foreign investments that are broader than those permissible for member banks, and (2) conduct a deposit and loan business in states, including those where the parent of the Edge or agreement corporation does not conduct such banking activities, provided that the business is strictly related to international or foreign business. Foreign banks may own Edge Act and agreement corporations. These corporations are examined by the Federal Reserve annually.[1]

2100.0.3 SUPERVISION OF FOREIGN BANKING ORGANIZATIONS OPERATING IN THE UNITED STATES

Although foreign banks have been operating in the United States for more than a century, before 1978 the U.S. branches and agencies of these banks were not subject to supervision or regulation by any federal banking agency. The International Banking Act of 1978 (IBA) created a federal regulatory structure for the activities of foreign banks with U.S. branches and agencies. The IBA also established a policy of "national treatment" for foreign banks operating in the United States to promote competitive equality between them and domestic institutions. This policy generally gives foreign banking organizations operating in the United States the same powers as U.S. banking organizations and subjects them to the same restrictions and obligations that apply to the domestic operations of U.S. banking organizations.

1. 12 CFR 211.13(b). See also SR letter 90-21, "Rating System for International Examinations."

The Foreign Bank Supervision Enhancement Act of 1991 (FBSEA) increased the responsibility and the authority of the Federal Reserve to regularly examine the U.S. operations of foreign banks. Under the FBSEA, U.S. branches and agencies of foreign banks must be examined on-site at least once every 12 months, although this period may be extended to 18 months if the branch or agency meets certain criteria.[2] Supervisory actions resulting from examinations may be taken by the Federal Reserve alone or in conjunction with other agencies. Representative offices of these institutions are also subject to examination by the Federal Reserve.[3]

The Federal Reserve coordinates the supervisory program for the U.S. operations of foreign banking organizations with other federal and state banking agencies. Since a foreign banking organization may have both federally chartered and state-chartered offices in the United States, the Federal Reserve plays a key role in assessing the condition of the organization's entire U.S. operations and the foreign banking organization's ability to support its U.S. operations.

In 2014, the Federal Reserve Board approved a final rule required by section 165 of the Dodd-Frank Act (which also requires enhanced prudential standards for large U.S. BHCs) to strengthen supervision and regulation of foreign banking organizations.[4] The final rule recognized that the U.S. operations of foreign banking organizations had become increasingly complex, interconnected, and concentrated, and established a number of enhanced prudential standards for foreign banking organizations to help increase the resiliency of their operations. The requirements of the final rule will bolster the capital and liquidity positions of the U.S. operations of foreign banking organizations and promote a level playing field among all banking firms operating in the United States. A foreign banking organization with U.S. non-branch assets of $50 billion or more is required to establish an intermediate holding company over its U.S. subsidiaries, which will facilitate consistent supervision and regulation of the U.S. operations of the foreign bank.[5] The foreign-owned U.S. intermediate holding company is generally subject to the same risk-based and leverage capital standards applicable to U.S. BHCs. The intermediate holding companies are also subject to the Federal Reserve's rules pertaining to regular capital plans and stress testing.

2. 12 CFR 211.26(c).
3. 12 CFR 211.26(a)2.

4. See 79 Fed. Reg. 17,240 (March 27, 2014) and the Federal Reserve Board's Regulation YY (12 CFR part 252); and Dodd-Frank Act, Pub. L. No. 111-203, July 21, 2010; 124 Stat. 1376.

5. The Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) increases the $50 billion asset threshold in section 165 in two stages. Immediately on the date of enactment, bank holding companies with total consolidated assets of less than $100 billion were no longer subject to section 165.6. Eighteen months after the date of enactment, the threshold is raised to $250 billion. EGRRCPA also provides that the Board may apply any enhanced prudential standard to bank holding companies between $100 billion and $250 billion in total consolidated assets. See the Board's July 6, 2018, "Statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)."

WHAT'S NEW IN THIS REVISED SECTION

This section has been updated for the various types of formal supervisory actions—corrective actions (i.e., cease and desist orders (including placing limits on the activities or functions of a BHC or institution-affiliated party), written agreements, suspensions (also removals and prohibitions), nonbank activity termination, violations of orders and written agreements, civil-money penalties (revised penalty amounts), etc.

In addition, the cease-and-desist order discussion has been expanded to include what an order may require from a BHC or person, and it provides a discussion of the nature of affirmative actions by a BHC or person that may need to be taken to restore the BHC to a safe and sound condition. The prohibition and removal discussion has been expanded to detail what entities or individuals that the Board may take action against. It also discusses the prohibition against any individual who has been convicted of a crime involving dishonesty, breach of trust, or money laundering, from serving, participating in, or owning or controlling a BHC, bank or nonbank subsidiary, or any affiliate thereof without the prior approval of the FDIC or in certain cases, the Federal Reserve Board. The discussion on indemnifications and payments includes a detailed discussion of the provisions of section 18(k) of the FDI Act and the FDIC's regulation on indemnification agreements and payments. The definition of a prohibited indemnification payment is included.

2110.0.1 STATUTORY TOOLS FOR FORMAL SUPERVISORY ACTION

Statutory tools are available to the Federal Reserve Board if formal supervisory action is warranted against a bank holding company (BHC) or nonbank subsidiaries, or against certain individuals associated with them. The objective of formal actions is to correct practices that the regulators believe to be unlawful, unsafe, or unsound. The initial consideration and determination of whether formal action is required usually results from an inspection. This section discusses the following topics:

1. Board jurisdiction under the law
2. actions or practices that may trigger the statutory remedies
3. Board staff procedures
4. the elements of a corrective order
5. temporary orders
6. written agreements
7. suspensions and removals
8. enforcement of orders
9. civil money penalties
10. termination of certain nonbank subsidiary activities or ownership

2110.0.2 TYPES OF CORRECTIVE ACTIONS

Generally, under section 8 of the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. 1818(b), the Board may use its cease and desist authority and other enforcement tools against (1) a BHC[1], (2) a nonbank subsidiary of a BHC, and (3) any institution-affiliated party. The term ''institution-affiliated party'' includes any director, officer, employee, controlling shareholder (other than a BHC), or agent, and any other person who has filed or is required to file a change in control notice. It also includes any shareholder, consultant, joint venture partner, or any other person who participates in the conduct of the affairs of a BHC or nonbank subsidiary, as well as any independent contractor, including attorneys, appraisers, and accountants who knowingly or recklessly participates in any violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, an institution.[2] The Board's jurisdiction over an institution-affiliated party extends for up to six years after the party's resignation, termination of employment, or separation caused by the closing of a financial institution, provided that any notice (such as a notice of intent to remove from office and of prohibition) is served on the party before the end of a six-year period.

1. The Board's authority under 12 U.S.C. 1818 also extends to savings and loan holding companies, their nonbank subsidiaries, and their institution-affiliated parties.

2. The Board is authorized to issue regulations further defining which individuals should be considered institution-affiliated parties. Similarly, the Board may determine whether an individual is an institution-affiliated party on a case-by-case basis (see 12 U.S.C. 1813(u)).

2110.0.2.1 Cease and Desist Orders

Generally, under 12 U.S.C. 1818(b), the Board may use its cease and desist authority against a BHC and any institution-affiliated party when it finds that the entity or party is engaging, has engaged, or is about to engage in (1) a violation of law, rule, or regulation; (2) a violation of a condition imposed in writing by the Board in connection with the granting of any application or any written agreement; or (3) an unsafe or unsound practice in conducting the business of the institution. Section 12 U.S.C. 1818(b)(3) makes clear that the cease and desist authority applies to BHCs and Edge and agreement corporations, as well as to all institution-affiliated parties associated with them.

A cease and desist order may require the BHC or person subject to the order to (1) cease and desist from the practices or violations or (2) take affirmative action to correct the violations or practices. Affirmative actions include actions necessary to restore the BHC to a safe and sound condition, such as measures to improve the BHC's consolidated capital, restricting dividends and new debt to conserve the BHC's assets so it can serve as a source of strength to the bank; employ qualified officers or employees; and any other action the Board determines to be appropriate. An individual may be required to reimburse the company for unauthorized or improper payments received, or both.

Most cease and desist orders are issued by consent. When Board staff, in conjunction with the appropriate Reserve Bank, determines that a cease and desist action is necessary, the BHC or party is permitted an opportunity to consent to the issuance of the order without the need for the issuance of a notice of charges and a contested administrative hearing. Board staff drafts the proposed cease and desist order and, with Reserve Bank staff, presents it to the BHC or individual for consent. BHCs and individuals are advised that they may have legal counsel present at all meetings with Board or Reserve Bank staff concerning formal supervisory actions. If the parties voluntarily agree to settle the case by the issuance of a consent cease and desist order, the proposed consent order will be presented to senior Board officials for approval, at which time the order will be final and binding.

When a BHC or person fails to consent to a cease and desist order, the Board may issue a notice of charges and of hearing to the entity or party. The notice of charges contains a detailed statement describing the facts constituting the alleged violations or unsafe or unsound practices. The issuance of the notice of charges and of hearing[3] starts a formal process that includes the convening of a public administrative hearing to be conducted before an administrative law judge, appointed by the Board. After the hearing, the judge makes a recommended decision to the Board. A hearing must be held within 30 to 60 days of service of the notice of charges, unless a later date is set by the administrative law judge. After the Board considers the record of the proceeding, including the administrative law judge's recommended decision, it determines whether to issue a final cease and desist order. BHCs and individuals who are subject to cease and desist orders that were issued as a result of contested proceedings may appeal the Board's issuance of the order to the appropriate federal court of appeals.

2110.0.2.2 Temporary Cease and Desist Orders

If a violation or threatened violation of law, rule, or regulation, or if engaging in an unsafe or unsound practice that is specified in the notice of charges is likely to cause the insolvency of a BHC or its subsidiary bank, weaken the condition of the BHC, cause a significant dissipation in earnings, or otherwise seriously prejudice the interests of subsidiary bank's depositors before the completion of the proceedings (initiated by the issuance of the notice of charges), the Board may, in conjunction with issuing a notice of charges, issue a temporary cease and desist order against the BHC or an institution-affiliated party to effect immediate correction (pursuant to 12 U.S.C. 1818(c)).

The Board may also issue a temporary order if it determines that a BHC's or nonbank subsidiary's books and records are so incomplete or inaccurate that the Board is unable to determine, through the normal supervisory process, the BHC's or nonbank subsidiary's financial condition or the details or purpose of any transaction that may have a material effect on the BHC's condition. The temporary order may require the BHC or nonbank subsidiary to take the same corrective actions as a cease and desist order. The advantage of issuing a temporary cease and

3. A private hearing may be held if the Board determines that holding a public hearing would be contrary to the public interest.

desist order is that it is effective immediately after it is served on the BHC or individual. Within 10 days after being served with a temporary order, however, the BHC or individual may appeal to a U.S. district court for relief from the order. Unless set aside by the district court, the temporary order stays in effect until the Board issues a final cease and desist order or dismisses the action.

2110.0.2.3 Written Agreements

When circumstances warrant, a written agreement may be used. The provisions of a written agreement may relate to any of the problems found at the institution or involving institution-affiliated parties. Written agreements are drafted by Board staff, in consultation with Reserve Bank staff, and must be approved by the Board's Director of the Division of Banking Supervision and Regulation. After approval by the General Counsel before issuance, the Reserve Bank may enter into the Written Agreement under delegated authority (12 C.F.R. 265.11(a)(15)).

2110.0.2.4 Prohibition and Removal Authority

The Board is authorized by 12 U.S.C. 1818(e) to remove any current institution-affiliated party of a BHC and its nonbank subsidiaries for certain violations and misconduct and to prohibit permanently from the banking industry any current or former institution-affiliated party from future involvement with any insured depository institution, bank or thrift holding company, and nonbank subsidiary. The Board is authorized to initiate removal or prohibition actions when

1. the institution-affiliated party has directly or indirectly—
   a. violated any law, regulation, cease and desist order, condition imposed in writing, or any written agreement;
   b. engaged in any unsafe or unsound practice; or
   c. breached a fiduciary duty; and
2. the Board determines that, because of the violation, unsafe or unsound practice, or breach—
   a. the institution has suffered or will suffer financial loss or other damage;
   b. the interests of depositors have been or could be prejudiced; or
   c. the institution-affiliated party has received financial gain or other benefit from the violation or practice; and
3. such violation, practice, or breach—
   a. involves personal dishonesty; or
   b. demonstrates a willful or continuing disregard for the safety or soundness of the institution.

The statute also authorizes the Board to initiate removal or prohibition actions against (1) any institution-affiliated party who has committed a violation of any provision of the Bank Secrecy Act that was not inadvertent or unintentional, (2) any officer or director who has knowledge that an institution-affiliated party has violated the money-laundering statutes and did not take appropriate action to stop or prevent the reoccurrence of such a violation, or (3) any officer or director who violates the prohibitions on management interlocks. The removal or prohibition actions for these violations do not require a finding of gain to the individual, loss to the institution, personal dishonesty, or willful or continuing disregard for the safety or soundness of the institution.[4]

Like a cease and desist order, a removal or prohibition order may be issued either by consent or after an administrative process initiated by the issuance of a notice of intent to remove and prohibit. If an institution-affiliated party's actions warrant immediate removal from the BHC, the Board is authorized to suspend the person temporarily from the BHC pending the outcome of the complete administrative process. An institution-affiliated party currently associated with a BHC may also be suspended or removed for cause based on actions taken while formerly associated with a different insured depository institution, BHC, or business institution. "Business institution" is not specifically defined in the statute so that it may be interpreted to include any other business interests of the institution-affiliated party.

Under 12 U.S.C. 1818(g), the Board is authorized to suspend from office or prohibit from further participation any institution-affiliated party charged or indicted for the commission of a crime involving personal dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under state or federal law, if the continued participation might threaten either the interests of depositors or public confidence in the institution. The Board may

4. See 12 U.S.C. 1818(e)(2).

also suspend or prohibit any individual charged with a violation of the money-laundering statutes. The suspension can remain in effect until the criminal action is disposed of or until the suspension is terminated by the Board. The Board may also initiate a removal or prohibition action against an institution-affiliated party who has been convicted of, or pleaded to, a crime involving personal dishonesty or breach of trust if his or her continued service would threaten the interests of the depositor or impair public confidence in the institution. The Board is required to issue such an order against any institution-affiliated party who has been convicted of, or pleaded to, a violation of the money-laundering statutes.

Furthermore, 12 U.S.C. 1829 prohibits any individual who has been convicted of a crime involving dishonesty, breach of trust, or money laundering from (1) serving as an institution-affiliated party of, (2) directly or indirectly participating in the affairs of, and (3) owning or controlling, directly or indirectly, an insured depository institution without the FDIC's prior approval. The statute also prohibits a convicted person from holding a position at a BHC or nonbank affiliate without the Board of Governors of the Federal Reserve System's prior approval. The penalty for violation of this law is a potential fine for a knowing violation of up to $1 million per day, imprisonment for up to five years, or both. The criminal penalty applies to both the individual and the employing institution.

2110.0.2.5 Termination of Nonbank Activity

The Board is authorized by 12 U.S.C. 1844(e) to order a BHC to terminate certain activities of its nonbank subsidiary (other than a nonbank subsidiary of a bank) or to sell its shares of the nonbank subsidiary. When the Board has reasonable cause to believe that the BHC's continuation of any activity or ownership or control of any of its nonbank subsidiaries constitutes a serious risk to the financial safety, soundness, or stability of the BHC, and if the activity, ownership, or control is inconsistent with sound banking principles or inconsistent with the purposes of the Bank Holding Company Act (BHC Act) or the Financial Institutions Supervisory Act of 1966, the Board may order the BHC to terminate the activity or sell control of the nonbank subsidiary.

2110.0.2.6 Violations of Final Orders and Written Agreements

When any final order or temporary cease and desist order has been violated, the Board may apply to a U.S. district court for enforcement of the action. Violations of final orders and written agreements may also give rise to the assessment of civil money penalties against the offending BHC or institution-affiliated parties, as circumstances warrant. The civil money penalty is assessed in the same manner as described in the "Civil Money Penalties" section below. Any institution-affiliated party who violates a suspension or removal order is subject to a criminal fine of up to $1 million, imprisonment for up to five years, or both.

2110.0.2.7 Civil Money Penalties

The Board may assess civil money penalties of up to $7,500 per day against any institution or institution-affiliated party for a violation of (1) law or regulation; (2) a final cease-and-desist, temporary cease and desist, suspension, removal, or prohibition order; (3) a condition imposed in writing by the Board in connection with the granting of an application or other request; and (4) a written agreement.

A fine of up to $37,500 per day can be assessed for a violation, an unsafe or unsound practice recklessly engaged in, or a breach of fiduciary duty when the violation, practice, or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss, or results in pecuniary gain or other benefit for the offender. A civil money penalty of up to $1.375 million per day can be assessed for any knowing violation, unsafe or unsound practice, or breach of any fiduciary duty when the offender knowingly or recklessly caused a substantial loss to the financial institution or received substantial pecuniary gain or other benefit. Civil money penalties may also be assessed, under the three-tier penalty framework described above, for any violation of the Change in Bank Control Act and for violations of the anti-tying provisions of federal banking law, among other provisions (12 U.S.C. 1972).

The Board may also assess civil money penalties for the submission of any late, false, or misleading reports required by the BHC Act and

Regulation Y of the Board. If a BHC maintains procedures that are reasonably adapted to avoid inadvertent errors and unintentionally fails to publish any report, submits any false or misleading report or information, or is minimally late with the report, it can be assessed a fine of up to $2,200 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. If the error was not inadvertent, a penalty of up to $32,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1.375 million or 1 percent of the BHC's assets can be assessed for each day of the violation. Notwithstanding the above, violations of the BHC Act (with the exception of late, false, or inaccurate report violations as described above) may be addressed by the assessment of civil money penalties of not more than $25,000 per day.

2110.0.2.8 Administration of Formal Actions

2110.0.2.8.1 Publication of Final Orders

Under 12 U.S.C. 1818(u), the Board is required to publish and make publicly available any final order issued for any administrative enforcement proceeding it initiates. These orders include cease and desist, removal, prohibition, and civil money penalty assessments. The Board is also required to publish and make publicly available any written agreement or other written statement that it may enforce, unless the Board determines that publication of the order or agreement would be contrary to the public interest.

2110.0.2.8.2 Public Hearings

Under 12 U.S.C. 1818(u), all formal hearings, including contested cease and desist, removal, and civil money penalty proceedings, are open to the public unless the Board determines that a public hearing would be contrary to the public interest. Transcripts of all testimony; copies of all documents submitted as evidence in the hearing, which could include examination and inspection reports and supporting documents (except those filed under seal); and all other documents, such as the notice and the administrative law judge's recommended decision, are available to the public. These documents could include examiner's workpapers, file memorandums, reports of examination and inspection, and correspondence between a problem institution or wrongdoer and the Federal Reserve Bank. Appropriate actions should always be taken to ensure that all written material prepared in connection with any supervisory matter be accurate and free of insupportable conclusions or opinions.

2110.0.2.8.3 Subpoena Power

Under 12 U.S.C. 1818(n), which is made applicable to BHCs by 12 U.S.C. 1818(b)(3) and 1844(f), the Board has the authority to issue subpoenas directly or through its delegated representatives, and it has the authority to administer oaths or take depositions in connection with an examination or inspection.

2110.0.3 INDEMNIFICATION PAYMENTS AND GOLDEN PARACHUTE PAYMENTS

In general, an indemnification payment is a payment that reimburses an insider for a specified liability or cost that the person incurred in connection with a Federal Reserve investigation or enforcement action. Golden parachute payments are severance payments or agreements to make severance payments that are paid or entered into at a time when the BHC or its subsidiary bank is in a troubled condition. These payments require the prior written approval of the institution's federal primary regulator and the concurrence of the FDIC. Although both types of payments fall under the same statute, section 18(k) of the FDI Act (12 U.S.C. 1828(k)) and the FDIC's accompanying regulations,[5] the two types of payments are quite different and distinct. However, some of the restrictions on these payments are the same or similar.

2110.0.3.1 Indemnification Agreements and Payments

BHCs may seek to indemnify their officers, directors, and employees from any judgments, fines, claims, or settlements, whether civil, criminal, or administrative. The bylaws of some

5. See the FDIC's golden parachute regulations in 12 C.F.R. 359.

BHCs may have broadly worded indemnification provisions, or the BHC may have entered into separate indemnification agreements that cover the ongoing activities of its own institution-affiliated parties. Such indemnification provisions may be inconsistent with federal banking law and regulations, as well as with safe and sound banking practices.

Supervisory and examiner staff should be alert to the limitations and prohibitions on indemnification imposed by section 18(k) of the FDI Act[6] and the regulations issued thereunder by the FDIC. The law and regulations apply to indemnification agreements and payments made by a BHC to any institution-affiliated party, regardless of the condition of the BHC. The purpose of the law and regulations is to preserve the deterrent effects of administrative enforcement actions (by ensuring that individuals subject to final enforcement actions bear the costs of any judgments, fines, and associated legal expenses) and to safeguard the assets of financial institutions.

A prohibited indemnification payment includes any payment (or agreement to make a payment) by a BHC to an institution-affiliated party to pay or reimburse such person for any liability or legal expense incurred in any Board administrative proceeding that results in a final order or settlement in which the institution-affiliated party is assessed a civil money penalty, is removed or prohibited from banking, or is required to cease an action or take any affirmative action, including making restitution, with respect to the BHC.[7]

The FDIC's regulations provide criteria for making permissible indemnification payments. A BHC may make or agree to make a reasonable indemnification payment if all of the following conditions are met: (i) the institution's board of directors determines in writing that the institution-affiliated party acted in good faith and the best interests of the institution; (ii) the board of directors determines that the payment will not materially affect the institution's safety and soundness; (iii) the payment does not fall within the definition of a prohibited indemnification payment; and (iv) the institution-affiliated party agrees in writing to reimburse the institution, to the extent not covered by permissible insurance, for payments made in the event that the institution-affiliated party does not prevail.

6. See 12 U.S.C. 1828(k).
7. See 12 C.F.R. 359.

The law and the FDIC's regulations reinforce the Federal Reserve's long-standing policy that an institution-affiliated party who engages in misconduct should not be insulated from the consequences of his or her misconduct. From a safety-and-soundness perspective, a BHC should not divert its assets to pay a fine or other final judgment issued against an institution-affiliated party for misconduct that presumably violates the BHC's policy of compliance with applicable law, especially when the individual's misconduct has already harmed the BHC.

BHCs should review their bylaws and any outstanding indemnification agreements, as well as insurance policies, to ensure that they conform with the requirements of federal law and regulations. If a BHC fails to take appropriate action to bring its indemnification provisions into compliance with federal laws and regulations, appropriate follow-up supervisory action may be taken. As part of the supervisory process, which will include merger and acquisition applications, the Federal Reserve's supervisory and examiner staff will review identified agreements having indemnification-related issues for compliance with federal laws and regulations. (See SR-02-17.)

2110.0.3.2 Golden Parachute Payments

The FDIC's golden parachute regulations apply to a BHC or its insured depository institution subsidiary that is in a troubled condition as defined in Regulation Y. The purposes of the law and regulations are to safeguard the assets of financial institutions and limit rewards to institution-affiliated parties who contributed to the institution's troubled condition.

In general, the FDIC's regulations prohibit BHCs and their insured depository institution subsidiaries from making golden parachute payments except in certain circumstances. A golden parachute payment means any payment in the nature of compensation (or agreement to make such payment) for the benefit of any current or former institution-affiliated party of a BHC or its insured depository institution subsidiary that meets three criteria. First, the payment or agreement must be contingent on the termination of the institution-affiliated party's employment or association. Second, the agreement is made or the payment received on or after, or made in contemplation of, among other things, a determination that the BHC or its insured depository institution subsidiary is in a troubled condition under the regulations of the applicable banking agency.[8] Third, the agreement is made or the payment is payable to an institution-affiliated party when a BHC or its insured depository institution subsidiary meets certain specific conditions, including being subject to a determination that it is in a troubled condition.

The definition of a golden parachute payment also covers a payment made by a BHC that is not in a troubled condition to an institution-affiliated party of an insured depository institution subsidiary that is in a troubled condition, if the other criteria in the definition are met. This circumstance may arise when a BHC, as part of an agreement to acquire a troubled bank or savings association, proposes to make payments to the troubled institution's institution-affiliated parties that are conditioned on their termination of employment.[9]

A BHC or state member bank may make or enter into an agreement to make a golden parachute payment only (1) if the Federal Reserve, with the written concurrence of the FDIC, determines that the payment or agreement is permissible; (2) as part of an agreement to hire competent management in certain conditions, with the consent of the Federal Reserve and the FDIC as to the amount and terms of the proposed payment; or (3) pursuant to an agreement to provide a reasonable severance not to exceed 12 months' salary in the event of an unassisted change in control of the depository institution, with the consent of the Federal Reserve. In determining the permissibility of the payment, the Federal Reserve may consider a variety of factors, including the individual's degree of managerial responsibilities and length of service, the reasonableness of the payment, and any other factors or circumstances that would indicate that the proposed payment would be contrary to the purposes of the statute or regulations.

A BHC or state member bank requesting approval to make a golden parachute payment or enter into an agreement to make such a payment should submit its request simultaneously to the appropriate FDIC regional office and the Reserve Bank. The request must detail the proposed payments and demonstrate that the BHC or state member bank does not possess and is not aware of any evidence that there is reasonable basis to believe, at the time the payment is proposed to be made, that (1) the institution-affiliated party receiving such a payment has committed any fraud, breach of fiduciary duty, or insider abuse or has materially violated any applicable banking law or regulation that had or is likely to have a material adverse effect on the BHC or state member bank; (2) the individual is substantially responsible for the institution's insolvency or troubled condition; and (3) the individual has violated specified banking or criminal laws.

Requests regarding golden parachute payments or agreements should be forwarded by the Reserve Bank to appropriate Board staff for a final determination on the permissibility of the payment. Golden parachute payments or agreements must be approved by the Board's Director of the Division of Banking Supervision and Regulation and the General Counsel. Denials are not delegated by the Board of Governors to Board or Reserve Bank staffs.

If a state member bank or BHC makes or enters into an agreement to make a golden parachute payment without prior regulatory approval when such approval is required, appropriate follow-up supervisory action should be taken. This follow-up could include an enforcement action requiring the offending institution-affiliated party to reimburse the institution for the amount of the prohibited payment. When a BHC or state member bank is identified as having golden parachute-related issues in the supervisory process, those issues should be carefully reviewed for compliance with the law and the FDIC's regulations. The appropriate Reserve Bank supervisory staff and the appropriate staff of the Board's Division of Banking Supervision and Regulation and Legal Division should be notified and consulted on the golden parachute-related issues.

8. See section 225.71 of Regulation Y (12 C.F.R. 225.71), which defines a "troubled condition" for a state member bank or BHC as an institution that (1) has a composite rating of 4 or 5; (2) is subject to a cease and desist order or formal written agreement that requires action to improve the institution's financial condition, unless otherwise informed in writing by the Federal Reserve; or (3) is informed in writing by the Federal Reserve that it is in a troubled condition.

9. The FDIC's regulations exclude from the definition of a golden parachute payment several types of payments, such as payments made pursuant to a qualified pension or retirement plan; a benefit plan or bona fide deferred compensation plan (which are further defined in the FDIC's regulations); or a severance plan that provides benefits to all eligible employees, does not exceed the base compensation paid over the preceding 12 months, and otherwise meets the regulatory definition of nondiscriminatory and other conditions in the FDIC's regulations.

2110.0.4 DISCIPLINARY ACTIONS AGAINST ACCOUNTANTS AND ACCOUNTING FIRMS PERFORMING CERTAIN AUDIT SERVICES

Section 36 of the FDI Act authorizes the federal bank regulatory agencies to take disciplinary actions against independent public accountants and accounting firms that perform audit services covered by the act's provisions. Section 36, as implemented by part 363 of the FDIC's rules (12 C.F.R. 363), requires that each federally insured depository institution with total assets of $500 million or more obtain an audit of its financial statements and an attestation on management's assertions concerning internal controls over financial reporting performed by an independent public accountant (the accountant). The insured depository institution must include the accountant's audit and attestation reports in its annual report.

The audit requirement can be fulfilled by an independent audit of a BHC where the insured subsidiary bank (1) has total assets of less than $5 billion or (2) has total assets of $5 billion or more and has a composite CAMELS rating of 1 or 2.

Section 36 and the rules enacted pursuant thereto set forth the practices and procedures to remove, suspend, or debar, for good cause,[10] an accountant or firm from performing audit and attestation services for an insured state member bank, or BHC that obtains audit services for an insured subsidiary bank. Immediate suspensions are permitted in limited circumstances. Also, an accountant or accounting firm is prohibited from performing audit services for the covered institution if an authorized agency has taken such a disciplinary action against the accountant or firm, or if the U.S. Securities and Exchange Commission or the Public Company Accounting Oversight Board has taken certain disciplinary action against the accountant or firm.

10. The rules provide that certain violations of law, negligent conduct, reckless violations of professional standards, or lack of qualifications to perform auditing services may be considered good cause.

2110.0.5 APPOINTMENT OF DIRECTORS AND SENIOR EXECUTIVE OFFICERS

Under section 32 of the FDI Act (12 U.S.C. 1831i) and subpart H of Regulation Y (12 C.F.R. 225.71 et seq.), any BHC or state member bank that is in troubled condition, or does not meet minimum capital standards, must provide 30 days' written notice to the Board before appointing any new director or senior executive officer,[11] or changing the responsibilities of any senior executive officer so that the officer would assume a different senior officer position. Subpart H of Regulation Y sets forth the procedures for filing and the content of the notice. If a BHC or state member bank that is in a troubled condition appoints a director or senior officer without the required 30 days' prior written notice, appropriate follow-up supervisory action should be taken.

The Board may disapprove a notice if it finds that the competence, experience, character, or integrity of the proposed individual indicates that his or her service would not be in the best interest of the institution's depositors or the public. A disapproved individual or the institution that filed the notice may appeal the Federal Reserve's notice of disapproval under the procedures set forth in Regulation Y. While the appeal is pending, the individual may not serve as a director or senior executive officer of a BHC or a state member bank.

11. The Board or Reserve Bank, under extraordinary circumstances, may permit an individual to serve as a director or senior executive officer before a notice is provided; however, this permission does not affect the Federal Reserve's authority to disapprove a notice within 30 days of its filing.

2120.0.1 INTRODUCTION

On January 17, 1978, the three federal bank supervisory agencies issued a joint policy statement to address their concern with regard to the potential for improper payments by banks and bank holding companies in violation of the Foreign Corrupt Practices Act and the Federal Election Campaign Act.

While not widespread, the federal bank supervisory agencies were concerned that such practices could reflect adversely on the banking system and constitute unsafe and unsound banking practices in addition to their possible illegality.

The potential devices for making political payments in violation of the law could include compensatory bonuses to employees, designated expense accounts, fees or salaries paid to officers, and preferential interest rate loans. In addition, political contributions could be made by providing equipment and services without charge to candidates for office. Refer to F.R.R.S. at 3–447.1 and 4–875.

2120.0.2 SUMMARY OF THE FEDERAL ELECTION CAMPAIGN ACT

The Federal Election Campaign Act (FECA), enacted in 1971, was designed to curb potential abuses in the area of federal election financing. In general, FECA regulates the making of campaign contributions and expenditures in connection with primary and general elections to federal offices. Since 1907, federal law has prohibited national banks from making contributions in connection with political elections. FECA does not specifically address the making of contributions and expenditures by banks or other corporations to advocate positions on issues that are the subjects of public referenda. As originally enacted, FECA required disclosure of contributions received or expenditures made; however, amendments to the law in 1974 and 1976 imposed additional limitations on contributions and expenditures as well. The 1974 amendments also established the Federal Election Commission (Commission) to administer FECA's provisions. The Commission is responsible for adopting rules to carry out FECA, for rendering advisory opinions, and for enforcing the Act. The Commission was reorganized as a result of the FECA Amendments of 1976, and it has issued regulations interpreting the statute (11 C.F.R.).

2120.0.3 BANKS AND THE FECA

National banks and other federally chartered corporations are specifically prohibited from making contributions or expenditures in connection with *any* election; other corporations, including banks and bank holding companies, may not make contributions or expenditures in connection with *federal* elections. However, corporations may establish and solicit contributions to ''separate segregated funds'' to be used for political purposes; these are discussed in greater detail below.

State member banks and bank holding companies may make contributions or expenditures that are consistent with state and local law in connection with state or local elections. Because many states have laws that prohibit or limit political contributions or expenditures by banks, familiarization with applicable state and local laws is a necessity. According to the joint policy statement of the three banking agencies, a political contribution must meet not only the requirement of legality but also the standards of safety and soundness. Thus, a contribution or expenditure, among other things, must be recorded properly on the bank's books, may not be excessive relative to the bank's size and condition, and may not involve self-dealing.

Banks may make loans to political candidates provided the loans satisfy the requirements set out below.

2120.0.4 CONTRIBUTIONS AND EXPENDITURES

The words ''contribution'' and ''expenditure'' are defined broadly by FECA and the Commission's regulations to include any loan, advance, deposit, purchase, payment, distribution, subscription or gift of money or anything of value which is made for the purpose of influencing the nomination or election of any person to federal office. The payment by a third party of compensation for personal services rendered without charge to a candidate or political committee is also treated as a contribution by FECA, although the term does *not* include the value of personal services provided by an individual without compensation on a volunteer basis.

Although loans are included in the definitions of contribution and expenditure under FECA, a specific exemption is provided for bank loans made in the ordinary course of business and in accordance with applicable banking laws and regulations. The Commission's regulations provide, further, that in order for extensions of credit to a candidate, political committee or other person in connection with a federal election to be treated as a loan and not a contribution, they must be on terms substantially similar to those made to non-political debtors and be similar in risk and amount. The regulations also provide that a debt may be forgiven only if the creditor has treated it in a commercially reasonable manner, including making efforts to collect the debt which are similar to the efforts it would make with a non-political debtor. In considering whether a particular transaction is a contribution or a loan, it is expected that a factor would be the extent to which the creditor may have departed from its customary credit risk analysis.

FECA and the implementing regulation permit certain limited payments to candidates or their political committees. For example, payment of compensation to a regular employee who is providing a candidate or political committee with legal or accounting services which are solely for the purpose of compliance with the provisions of the FECA is exempt from the definitions of contribution and expenditure. The Commission's regulations also permit occasional use of a corporation's facilities by its shareholders and employees for volunteer political activity; however, reimbursement to the corporation is required for the normal rental charge for anything more than occasional or incidental use.

2120.0.5 SEPARATE SEGREGATED FUNDS AND POLITICAL COMMITTEES

FECA allows the establishment and administration by corporations of "separate segregated funds" to be utilized for political purposes. While corporate monies may not be used to make political contributions or expenditures, corporations may bear the costs of establishing and administering these separate segregated funds, including payment of rent for office space, utilities, supplies and salaries. These costs need not be disclosed under FECA. Commission regulations also permit a corporation to exercise control over its separate segregated fund.

In practice, most corporate segregated funds are administered by a group of corporate personnel, which, if the fund receives any contributions or makes any expenditures during a calendar year, constitutes a "political committee," as defined by FECA. As such, it is required to file a statement of organization with the Commission, to keep detailed records of contributions and expenditures, and to file with the Commission reports identifying contributions in excess of $200 and candidates who are recipients of contributions from the fund.

Solicitation of contributions to corporate segregated funds by political committees must be accomplished within the precise limits established by FECA. All solicitations directed to corporate employees must satisfy the following requirements: (1) the contribution must be entirely voluntary; (2) the employee must be informed of the political purposes of the fund at the time of the solicitation; and (3) the employee must be informed of his right to refuse to contribute without reprisal. Beyond those basic requirements, FECA distinguishes between "executive and administrative" personnel and other employees. The former and their families may be solicited any number of times, while the latter and their families may only be solicited through a maximum of two written solicitations per year, and these solicitations must be addressed to the employees at their homes. Solicitations may also be directed to corporate stockholders and their families in the same manner as to executive and administrative personnel.

Although a corporation, or a corporation and its subsidiaries, may form several political committees, for purposes of determining the statutory limitations on contributions and expenditures, all committees established by a corporation and its subsidiaries are treated as one. Thus, the total amount which all political committees of a corporation and its subsidiaries may make to a single candidate is $5,000 in any federal election (provided that the committees are qualified multicandidate committees under FECA).

2120.0.6 INSPECTION OBJECTIVES

1. To determine if the company has made improper or illegal payments in violation of either of these statutes, and regardless of legality, and whether they constitute an unsafe and unsound banking practice.

2. To determine if controls have been established to prevent unproper payments in violation of these statutes.

2120.0.7 INSPECTION PROCEDURES

1. Determine whether the company and its nonbank subsidiaries have a policy prohibiting improper or illegal payments, bribes, kickbacks, or loans covered by either the Foreign Corrupt Practices Act or the Federal Election Campaign Act.

2. Determine how the policy, if any, has been communicated to officers, employees, or agents of the organization.

3. Review any investigation or study performed by, or on behalf of, the board of directors that evaluates policy or operations associated with the advancement of funds in possible violation of the statutes mentioned above. In addition, ascertain whether the organization has been investigated by any other government agency in connection with possible violations of the statutes and, if this is the case, review available materials associated with the investigation.

4. Review and analyze any internal or external audit program employed by the organization to determine whether the internal and external auditors have established appropriate routines to identify improper or illegal payments under the statutes. In connection with the evaluation of the adequacy of any audit program, the examiner should:

   a. Determine whether the auditor is aware of the provisions of the Foreign Corrupt Practices Act and the Federal Election Campaign Act and whether audit programs are in place which check for compliance with these laws;

   b. Review such programs and the results of any audits; and

   c. Determine whether the program directs the auditor to be alert to unusual entries or charges which might indicate that improper or illegal payments have been made to persons or organizations covered by the statutes.

5. Analyze the general level of internal control to determine whether there is sufficient protection against improper or illegal payments being irregularly recorded on the organization's books.

6. Both the examiner and assistants should be alert in the course of their usual inspection procedures for any transactions, or the use of organization services or equipment, which might indicate a violation of the statutes. Examination personnel should pay particular attention to:

   a. Commercial and other loans (including participations), which may have been made in connection with a political campaign, to assure that any such loans were made in the ordinary course of business in accordance with applicable laws.

   b. Income and expense ledger accounts for unusual entries including unusual debit entries (reductions) in income accounts or unusual credit entries (reductions) in expense accounts, significant deviations from the normal amount of recurring entries, and significant entries from an unusual source, such as a journal entry.

Procedure 7, following here, should only be undertaken in cases in which the examiner believes that there is some sufficient evidence indicating that improper or illegal payments have occurred. Such evidence would justify the implementation of these additional procedures.

7. Verification of audit programs and internal controls.

   a. Randomly select charged-off loan files and determine whether any charged-off loans were made to (i) foreign government officials or other persons or organizations covered by the Foreign Corrupt Practices Act, or (ii) persons or organizations covered under the Federal Election Campaign Act.

   b. For those significant income and expense accounts on which verification procedures have not been performed: (i) prepare an analysis of the account for the period since the last examination, preferably by month, and note any unusual fluctuations for which explanations should be obtained, and (ii) obtain an explanation for significant fluctuations or any unusual items through discussions with organization personnel and review of supporting documents.

2120.0.8 APPARENT VIOLATIONS OF THE STATUTES

Where violations of law or unsafe and unsound banking practices result from improper payments, the Federal Reserve System should exercise its full legal authority, including cease-and-desist proceedings and referral to the appropriate law enforcement agency for further action, to ensure that such practices are terminated. In appropriate circumstances, the fact that such payments have been made may reflect so adversely on an organization's management as to be a relevant factor in connection with the consideration of applications submitted by the organization.

In addition, the Reserve Bank should forward any information on apparent violations of the Federal Election Campaign Act to the Federal Election Commission. The Federal Election Commission is authorized to enforce FECA. The Commission may be prompted to investigate possible illegal payments by either a sworn statement submitted by an individual alleging a violation of the law, or on its own initiative based on information it has obtained in the course of carrying out its supervisory responsibilities. When the Commission determines that there is probable cause to believe a violation has occurred or is about to occur, it endeavors to enter into a conciliation agreement with the violator. If, however, it finds probable cause to believe that a willful violation has occurred or is about to occur, it may refer the matter directly to the Department of Justice for possible criminal prosecution, without having first attempted conciliation.

If informal means of conciliation fail, the Commission may begin civil proceedings to obtain relief. Should the Commission prevail, a maximum penalty of a fine equal to the greater of $10,000 or 200 percent of the amount of the illegal payment may be imposed. Knowing and willful violations involving over $1,000 may subject the violator to a fine, up to the greater of $25,000 or 300 percent of the illegal payment, and imprisonment for up to one year.

2120.0.9 ADVISORY OPINIONS

Any person, including a bank or a corporation, may request an advisory opinion concerning the application of FECA or of the Commission's regulations to a specific transaction or activity in which that person wishes to engage. The Commission must render such advisory opinion within 60 days from receipt of a complete request. Banks or bank employees wishing to engage in activity which may be regulated by FECA are encouraged to request advisory opinions from the Commission.

Techniques, practices, and tools for credit-risk management evolve with the challenges that firms face in their business-lending activities. For larger firms, the number and geographic dispersion of their borrowers make it increasingly difficult for such firms to manage their loan portfolios simply by remaining closely attuned to the performance of each borrower. As a result, one increasingly important component of the systems for controlling credit risk at larger firms is the identification of gradations in credit risk among their commercial loans, and the assignment of internal credit-risk ratings to loans that correspond to these gradations. The use of an internal rating process is appropriate and important for sound risk management at large firms. See SR-98-25, "Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations."

Effective internal rating systems support sophisticated credit-risk management. Supervisors and examiners, both in their inspections and other contacts with firms, should emphasize the importance of development and implementation of effective internal credit-rating systems and the critical role such systems should play in a firm's credit-risk-management process.

Internal rating systems are used at large firms for a range of purposes. At one end of this range, they are primarily used to determine approval requirements and identify problem loans. At the other end, the internal rating systems are an integral element of credit-portfolio monitoring and management, capital allocation, the pricing of credit, profitability analysis, and the detailed analysis to support the allowance. Internal rating systems being used for these latter purposes should be significantly richer and more robust than systems used for the purposes such as approval requirements and identifying problem loans.

A sound risk-management process should adequately illuminate the risks being taken to enable management to initiate and apply appropriate controls that balance risks against returns. Furthermore, the process should provide information as to the firm's overall appetite for risk, considering the uncertainties faced by lenders and the long-term viability of the firm. Accordingly, large firms should have strong risk-rating systems that address the range of lending activity and provide timely and accurate information for the firm's management to monitor, manage, and control credit risk. The rating system should also consider (1) the overall composition of the various portfolios by loan type, terms, and tenure, (2) an assessment of the risk exposure and credit concentrations to a particular type of loan, borrower, market, or industry and (3) information on risk profiles of individual borrowers. Moreover, such rating systems have an important role in (1) establishing an appropriate level for the allowance, (2) conducting internal analyses of loan and relationship profitability, (3) assessing capital adequacy, and possibly (4) administering performance-based compensation.[1]

Examiners should evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing both asset quality and the overall strength of a firm's risk management. In doing so, examiners should be cognizant that an internal risk-identification and -monitoring system should be consistent with the nature, size, and complexity of the firm's activities.

2122.0.1 APPLICATION TO LARGE HOLDING COMPANIES

The guidance provided in this section should be considered in scoping supervisory activities at "large" bank holding companies and savings and loan holding companies (collectively referred to as "firms" or "large firms").[2] In this context, those firms with significant involvement in relevant secondary-market credit activities, such as securitization of business loans or credit derivatives, should have more elaborate and formal approaches for managing the risks associated with these activities.[3] Structured and sophisticated arrangements for managing credit risk are more appropriate for larger firms than for smaller and less complex institutions. In performing their evaluation, examiners should also consider whether other elements of the risk-management process might compensate for any specific weaknesses attributable to an inadequate rating system.

1. See the Board's Regulation Q (12 CFR part 217) for more information on capital requirements.

2. See SR-14-9, "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program," for more information.

3. Secondary-market credit activities generally include loan syndications, loan sales and participations, credit derivatives, and asset securitizations, as well as the provision of credit enhancements and liquidity facilities to such transactions. Such activities are described further in section 2129.05.

In addition, examiners should review a firm's internal management information system reports to determine whether the portion of loans in lower-quality pass grades has grown significantly over time, and whether any such change might have negative implications for the adequacy of a firm's risk management or capital. Examiners should also consider whether a significant migration to higher-risk pass grades, or an overall large proportion of loans in a higher-risk pass grade, could have negative implications for the firm's asset-quality, including the adequacy of the allowance. Examiners should evaluate trends in categories associated with problem assets.

Examiners should discuss these issues, including a firm's plans to enhance existing credit-rating systems, with management. Inspection comments on the adequacy of risk-rating systems and the credit quality of the pass portfolio should be incorporated within the inspection report, noting deficiencies where appropriate.

2122.0.2 SOUND PRACTICES IN FUNCTION AND DESIGN OF INTERNAL RATING SYSTEMS

A consistent and meaningful internal risk-rating system is useful for differentiating the degree of credit risk in loans and other sources of credit exposure. Although assigning such risk ratings necessarily involves subjective judgment and experience, a properly designed rating system will allow this judgment to be applied in a structured and consistent manner.

Credit-risk ratings are designed to reflect the quality of a loan or other credit exposure, and thus, explicitly or implicitly, the loss characteristics of that loan or exposure. In many instances, large firms link ratings' definitions to one or more measurable outcomes such as the probability of a borrower's default or expected loss, which couples the probability of default with some estimate of the amount of loss to be incurred in the event that a default occurs. In addition, credit-risk ratings may reflect the likelihood or severity of loss as well as the variability of loss over time, particularly as this relates to the effect of the business cycle. Linkage to these measurable outcomes gives greater clarity to risk-rating analysis and allows for more consistent evaluation of performance against relevant benchmarks.

A firm may distinguish the risks associated with the borrowing entity (essentially default risk) from the risks stemming from a particular transaction or structure (more oriented to loss in event of default). In documenting its credit-administration procedures, a firm should clearly identify whether risk ratings reflect the risk of the borrower or the risk of the specific transaction. In this regard, a firm may assign both a borrower and facility rating, based on an analysis of the loan's obligor and the structure and terms of the particular loan (that is, collateral or guarantees) which may strengthen or weaken the quality of the loan.

An effective rating scale should distinguish gradations of risk within a firm's portfolio so that there is clear linkage to loan quality (and/or loss characteristics), rather than just to levels of administrative attention.[4] Therefore, the rating system should be designed to address the range of risks typically encountered in the underlying businesses in the firm's loan portfolio. One reflection of this degree of meaning is that there should be a fairly wide distribution of a portfolio's outstanding loans or exposures across the rating grades, unless the loan portfolio is genuinely homogeneous. Many rating systems include grades intended solely to capture credits needing heightened administrative attention, such as so-called "watch" grades. Prompt and systematic tracking of credits requiring such attention is an essential element of risk management. However, to the extent such loans vary in the risk characteristics, isolating these loans in a single grade may detract from the rating system's ability to indicate risk. Therefore, a firm may use separate or auxiliary indicators to monitor risks in these loans.

Risk-rating systems that only identify loans that are classified for supervisory purposes or that require additional monitoring (that is, "watch" loans) generally are not sufficiently comprehensive in distinguishing risks. Such systems contribute little or nothing to evaluating the majority of loans in the portfolio—that is, loans for which no specific difficulties are present or foreseen. In some cases, these firms might also establish one or two risk grades for loans with limited perceived risk, such as those collateralized by cash or liquid securities. A conse-

4. See SR-20-13, "Interagency Guidance on Credit Risk Review Systems," for more information. Internal risk-rating systems and/or supporting documentation should be sufficient to enable examiners to reconcile the totals for the various internal risk ratings under the institution's system to the federal banking agencies' categories for those loans graded below "pass" (that includes special mention, substandard, doubtful, or loss).

quence of the ineffective rating systems described above is that the bulk of the loan portfolio falls into one or two remaining broad risk grades—representing “pass” loans that are neither extremely low risk nor current or emerging problem credits—even though such grades may encompass many different levels of underlying credit risk.

2122.0.3 SOUND PRACTICES IN ASSIGNING AND VALIDATING INTERNAL RISK RATINGS

Objective ratings criteria as well as experience and judgment are critical both in making the credit decision and in assigning internal risk grades. Firms should develop clear and explicit criteria for each risk grade in their credit policies to promote consistency in assigning and reviewing grades. Criteria should be specified, even when addressing subjective or qualitative considerations, that allow for consistent assignment of risk grades to transactions with similar risk characteristics. Such criteria should include guidance both on the factors that should be considered in assigning a grade and how these factors should be weighed in arriving at a final grade.

Establishing clear rating criteria can promote consistency in assessing the financial condition of the borrower and other objective indicators of a transaction’s risk. One vehicle for enhancing the degree of consistency and accuracy is the use of “guidance” or “target” financial ratios or other objective indicators of the borrower’s financial performance as a point of comparison when assigning grades. Firms may also provide explicit linkages between internal grades and credit ratings issued by external parties as a reference point, for example, senior public debt ratings issued by one or more major ratings agencies. The use of default probability models, bankruptcy scoring, or other analytical tools can also be useful as supporting analysis. However, firms employing such techniques should identify the probability of default that is “typical” of each grade. The borrower’s primary industry may also be considered, both in terms of establishing the broad characteristics of borrowers in an industry (for example, degree of vulnerability to economic cycles or long-term favorable or unfavorable trends in the industry) as well as a borrower’s market share or competitive position in the industry.

In addition to quantitative indicators and tools, credit policies and ratings definitions should also cite qualitative factors that are incorporated into the assignment of a loan’s rating. This might include (1) the strength and experience of the borrower’s management, (2) the quality of financial information provided, and (3) the access of the borrower to alternative sources of funding. Addressing qualitative considerations in a structured and consistent manner when assigning a risk rating often requires experience and business judgment. Nonetheless, adequate consideration of these factors is important to assessing the risk of a transaction appropriately. In this regard, firms may choose to cite significant and specific points of comparison for qualitative factors in describing how such considerations can affect the rating (for example, whether a borrower’s financial statements have been audited or merely compiled by its accountants, or whether collateral has been independently valued).

Some formalization of the rating process can be helpful in promoting accuracy and consistency. For example, the use of a ‘‘risk-ratings analysis form’’ can be utilized to (1) provide structure for identifying and addressing the relevant qualitative and quantitative elements for determining internal risk grades, and (2) document a loan’s rating and the analysis or discussion of key quantitative and qualitative information utilized in assigning the rating.

Risk ratings should be reviewed, if not assigned, by independent credit-risk management or loan-review personnel both at the time the transaction is consummated and periodically over the life of the loan.[5] Such independent reviewers should reflect a level of experience and business judgment that is comparable to that of the line staff responsible for assigning and reviewing initial risk grades. An effective independent review should assess whether risk-rating changes (and particularly downgrades) have been timely and appropriate. Independent reviews of individual ratings support the discipline of the rating assignments by allowing management to evaluate the performance of those individuals assigning and reviewing risk ratings. If a firm relies on outside consultants, auditors, or other third parties to perform all or part of this review role, such individuals should have appropriate credit assessment experience and have a clear understanding of the firm’s policies and its risk-rating process.

Finally, firms should track performance or effectiveness of grades over time to gauge the

5. See section 2010.10 regarding internal loan review.

adequacy of its internal rating system. This may encompass the migration, consistency, and default/loss characteristics of assigned risk grades. Such tracking also allows for ex post analysis of the loss characteristics of loans in each risk grade.

Because ratings are typically applied to different types of loans—for example, to both commercial real estate and commercial loans—it is important that each grade retains the same meaning to the firm (in terms of overall risk) across the exposure types. Such comparability allows management to treat loans in high-risk grades as a potential concentration of credit risk and to manage them accordingly. It also allows management to monitor the overall degree of risk, and changes in the risk makeup, of the portfolio. Such consistency further permits risk grades to become a reliable input into portfolio credit-risk models.[6]

2122.0.4 APPLICATION OF INTERNAL RISK RATINGS TO INTERNAL MANAGEMENT AND ANALYSIS

As noted earlier, robust internal credit-rating systems are an important element in several key areas of the risk-management process. A firm should periodically assess and modify its system to confirm that credit ratings provide accurate and consistent indications of risk and are sufficiently granular to distinguish the degree of risk, especially for riskier assets. Described below are examples of risk management and analysis approaches for internal risk-rating systems.

2122.0.4.1 Limits and Approval Requirements

Many large firms have different approval requirements and thresholds for each internal grade, allowing less scrutiny and greater latitude in decision making for loans with a lower grade. While this appears reasonable, firms should also consider whether the level of intensity in approval process (or the degree to which limits are higher) is supported by the degree of a loan's risk and uncertainty associated with the future performance of the loan. If not, lower approval requirements may provide incentives to rate loans too favorably with resulting under-assessment of a loan's risk.

2122.0.4.2 Reporting to Management on Credit-Risk Profile of the Portfolio

Reports that analyze the overall credit risk in a firm's loan portfolios should include information on the profile of actual outstanding balances, exposures, or both by internal risk grade.[7] Further, to aid a firm to evaluate its risk appetite, the information should address concentrations in particular industries or borrower types. Portfolio analysis may range from aggregating loans by risk grade to risk modeling the potential behavior of a loan portfolio. Such analysis should consider the interaction between loans by type of credit and industry of borrowers. Gradations of risk reflect only one among many dimensions of portfolio risk, along with potential industry concentrations, exposure to an unfavorable turn in the business cycle, geographical concentrations, and other factors.

2122.0.4.3 Allowance

The makeup of the loan portfolio and the loss characteristics of each grade—including individual pass grades—should be considered, along with other factors, in determining the adequacy of an institution's allowance.

2122.0.4.4 Pricing and Profitability

To remain competitive, a firm will consider the appropriateness of loan pricing, particularly with regard to any single transaction or group of transactions. One way that some firms choose to enhance the discipline in their overall pricing practices across their portfolio is by incorporating risk-rating-specific loss factors in the determination of the minimum profitability requirements (that is, "hurdle rates"). Following this practice may render such firms less likely to price loans well below the level indicated by the long-term risk of the transaction.

6. See SR 11-7, "Guidance on Model Risk Management."

7. See section 2010.2 regarding a holding company's supervision of its subsidiaries and loan administration.