

## PURPOSE AND THE ROLE OF GUIDANCE

The *Bank Holding Company Supervision Manual* is prepared by Federal Reserve supervision personnel to provide guidance to examiners as they conduct inspections of bank holding companies and their nonbank subsidiaries as well as savings and loan holding companies. The manual is a compilation of formalized procedures and Board supervisory policies that examiners and supervision personnel should follow for the supervision of these organizations. It also discusses the relevant statutes, regulations, interpretations, and orders that pertain to holding company supervision. The manual enhances the staff's ability to implement the Board's inspection, supervisory, and monitoring activities, which is integral to the Federal Reserve's supervision program for organizations operating under a holding company structure. This manual is periodically updated on the Board's public website to reflect the latest supervisory policy and procedures and to address changes in industry risk-management practices.<sup>1</sup>

The Federal Reserve and the other banking and regulatory agencies issue various types of supervisory guidance, including interagency statements, advisories, bulletins, policy statements, questions and answers, and frequently asked questions, to their respective supervised institutions. Unlike a law or regulation, supervisory guidance does not have the force and effect of law, and the Federal Reserve does not take enforcement actions based on supervisory guidance.<sup>2</sup> Rather, supervisory guidance outlines the Federal Reserve's supervisory expectations or priorities and articulates its general views regarding appropriate practices for a given subject area. Supervisory guidance often provides examples of practices that the Federal Reserve generally considers consistent with safety-and-soundness standards or other applicable laws and regulations, including those designed to protect consumers. See "Statement Clarifying the Role of Supervisory Guidance," (12 C.F.R. part 262, appendix A).

This manual is designed to provide guidance to examination and supervision personnel. *It should not be considered a legal reference docu-*

*ment.* Questions concerning the applicability of and compliance with federal laws and regulations should be referred to appropriate legal counsel.

## USE OF THE MANUAL

The *Bank Holding Company Supervision Manual* is presented in "sections" which have been grouped together into "parts" that have in common a central theme pertaining to holding company supervision. For example, Part I provides an overview of the supervisory process of holding companies. Part II is composed of sections that discuss topics of special interest for supervisory review. Part III is composed of sections that discuss the various exemptive provisions to the nonbank prohibitions of the Bank Holding Company Act. Part IV presents sections on the preparation of a financial analysis.

The content of the sections within parts II–IV are grouped into four broad categories: (1) Main Section Content (2) Inspection Objectives, (3) Inspection Procedures, and (4) Laws, Regulations, Interpretations, and Orders. Not all of the categories are presented in each section. This manual uses a numbering system for organizing and referencing content. Content in subsections with headings having "tenths" or one decimal point generally provide higher-level or foundational information. Content under subheadings with several decimal points convey more detailed information.

Where a particular topic is exclusively financially related and does not involve legal considerations, the subsection on "Laws, Regulations," may be omitted. These procedures were designed for a full-scope, comprehensive inspection. It is recognized that in some instances the procedures may not apply in their entirety to all holding companies. Examiners should exercise supervisory judgment in completing procedures depending upon the characteristics of the organization under inspection.

1. <https://www.federalreserve.gov/boarddocs/supmanual/>

2. Government agencies issue regulations that generally have the force and effect of law. Such regulations generally take effect only after the agency proposes the regulation to the public and responds to comments on the proposal in a final rulemaking document.

TYPES OF HOLDING COMPANIES

Bank Holding Companies (Including Financial Holding Companies)

Banks are often owned or controlled by another company, called a bank holding company (BHC). The Federal Reserve has supervisory and regulatory authority for all BHCs, regardless of whether subsidiary banks of the holding company are national banks, state member banks, or state nonmember banks. The Federal Reserve also has supervisory authority over any nonbank subsidiary of a BHC that is not functionally regulated by another federal or state supervisor, such as a leasing subsidiary.

The Gramm-Leach-Bliley Act of 1999 permits BHCs that meet certain criteria to become financial holding companies (FHCs), which are also under Federal Reserve’s supervisory and regulatory authority. FHCs engage in an expanded list of activities including securities underwriting and dealing, merchant banking, insurance underwriting, and the sale of insurance. When an FHC engages in these activities, the Federal Reserve coordinates its supervisory efforts with those of the subsidiary’s functional regulator—for example, the U.S. Securities and Exchange Commission in the case of a broker-dealer, and state insurance regulators in the case of an insurance company.

Savings and Loan Holding Companies

Savings and loan holding companies (SLHCs) directly or indirectly control a savings association. Federal savings associations (those with federal charters) are supervised by the Office of the Comptroller of the Currency, while state-chartered savings associations are generally supervised by the Federal Deposit Insurance Corporation and their chartering state. Besides owning federal and/or state savings associations, an SLHC that meets capital and management requirements and elects to be treated as a financial holding company may also engage in activities as if it were a FHC that controls a bank.

Historically, SLHCs were regulated by other agencies: at first, the Federal Home Loan Bank Board, and more recently, by the Office of Thrift Supervision (OTS). In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act eliminated the OTS and transferred supervisory and regulatory responsibilities for SLHCs to the Federal Reserve. As a result, the Federal Reserve supervises and regulates all SLHCs regardless of the charter of the subsidiary savings associations. The Federal Reserve coordinates its supervisory efforts with the appropriate functional regulator(s) for a savings association or the SLHC’s subsidiary.

### 1020.0.1 INTRODUCTION

Under the Home Owners' Loan Act (HOLA), a savings and loan holding company (SLHC) includes any company, other than a bank holding company (BHC), that directly or indirectly controls either a savings association or any other company that is an SLHC.<sup>1</sup> Depository institution subsidiaries of SLHCs may have either a federal or a state charter. Federally chartered savings associations are supervised by the Office of the Comptroller of the Currency (OCC). State-chartered savings banks and cooperative banks may also elect to be deemed a savings association for purposes of section 10 of HOLA, causing their holding company to be an SLHC.<sup>2</sup> State-chartered savings banks and cooperative banks that have elected such treatment under section 10(l) are generally supervised by the Federal Deposit Insurance Corporation (FDIC) and their chartering state. The Federal Reserve supervises and regulates all SLHCs regardless of the charters of the subsidiary depository institution.

The Board of Governors of the Federal Reserve System (Board) supervises and regulates companies that control one or more banks. Congress gave the Board regulatory and supervisory authority over BHCs through the Bank Holding Company Act of 1956 (BHC Act).<sup>3</sup> In many respects, SLHCs are similar to BHCs. As with BHCs, an SLHC that meets certain criteria may also elect to be a financial holding company.

SLHCs differ from BHCs in several important ways. SLHCs may engage in a wider array of activities than BHCs. For example, the types of businesses operated by companies that own savings associations include securities brokers and dealers, insurance underwriters and agents, manufacturing firms, and retail companies. Further, SLHCs may have concentrations in commercial mortgage lending that are not typical for BHCs.

### 1020.0.2 THE FEDERAL RESERVE'S AUTHORITY OVER SAVINGS AND LOAN HOLDING COMPANIES

The Board's regulation and supervision of SLHCs began July 21, 2011, when provisions of the Dodd-Frank Act transferring supervision and regulation of SLHCs from the former Office of Thrift Supervision (OTS) to the Board took effect.<sup>4</sup> The Dodd-Frank Act also provides that all regulations, guidelines, and other advisory materials issued by the OTS on or before the transfer date with respect to SLHCs and their nondepository subsidiaries will be enforceable until modified, terminated, set aside, or superseded.<sup>5</sup> Upon this transfer, the Board became the federal supervisory agency for all depository institution holding companies, including a portfolio of SLHCs significantly engaged in insurance activities.

### 1020.0.3 KEY STATUTES, REGULATIONS, AND GUIDANCE THAT APPLY TO SLHCs

The main governing statute for SLHCs is HOLA. Other statutes apply to both SLHCs and BHCs, such as the Change in Bank Control Act and the Management Interlocks Act. The Board also has implemented various regulations that are relevant to SLHCs.

#### 1020.0.3.1 Regulation LL

Regulation LL (12 C.F.R. part 238) sets forth requirements generally governing SLHCs.<sup>6</sup> Regulation LL covers the acquisition of control of savings associations and defines and regulates the activities of SLHCs. Regulation LL also sets forth procedures under which directors and executive officers may be appointed or employed.

In the development of Regulation LL, the Board aimed to collect OTS regulations applicable to SLHCs (other than regulations pertaining uniquely to SLHCs in mutual form) and transfer them into a single part of chapter 2 of title 12 for

1. 12 U.S.C. 1467a(a)(1)(D)(i). The Board's Regulation LL (12 C.F.R. part 238) provides more detailed information on the definition of an SLHC. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amended HOLA to exclude from the definition of an SLHC any company that controls only one savings association subsidiary, provided that subsidiary functions solely in a trust or fiduciary capacity, as described in section 2(c)(2)(D) of the Bank Holding Company Act (BHC Act). See also, [SR-11-12](#), "Deregistration Procedures for Certain Savings and Loan Holding Companies."

2. 12 U.S.C. § 1467a(l).

3. Ch. 240, 70 Stat. 133.

4. Pub. L. 111-203, 124 Stat. 1376 (2010); Dodd-Frank Act tit. III, 124 Stat. at 1520–70.

5. 12 U.S.C. § 5414(b).

6. 76 Fed. Reg. 56,507 (September 13, 2011).

ease of locating. Generally, the structure of Regulation LL closely follows that of the Board’s Regulation Y (12 C.F.R. part 225), which houses regulations directly related to BHCs, in order to provide an overall structure to rules that were previously found in disparate locations.

Certain requirements of Regulation LL are only applicable to large SLHCs. For instance, Regulation LL establishes capital planning requirements for large SLHCs.<sup>7</sup> Regulation LL includes the risk-based categories of banking organizations that are subject to prudential standards for large U.S. banking organizations and foreign banking organizations, consistent with section 165 of the Dodd-Frank Act, as amended by the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), and with HOLA.<sup>8</sup> Large SLHCs are subject to certain prudential standards, including standards relating to liquidity, risk management, stress testing, and single-counterparty credit limits, to reflect the risk profile of the banking organization. These SLHCs are also subject to the Board’s company-run stress test and supervisory stress test rules, consistent with section 401 of EGRRCPA.<sup>9</sup>

*Safe and Sound Operations*

A fundamental and long-standing principle underlying the Federal Reserve’s supervision and regulation of BHCs is that they should serve as sources of financial and managerial strength to their subsidiary banks.<sup>10</sup> The Federal Deposit Insurance Act (FDIA) requires that a BHC act as a source of strength to its depository institution(s). FDIA defines the term “source of strength,” which generally means the ability of a company to provide financial assistance to an insured depository institution that the company directly or indirectly owns or controls, in the event of financial stress to the insured depository institution.

Section 616(d) of the Dodd-Frank Act revised section 38A of the FDIA to require a SLHC and any other company (including a BHC) that controls an insured depository institution to act as a source of strength to its depository institution. The board implemented the source of strength requirement into Regulation LL, which explicitly states that an “SLHC shall serve as a source of financial and managerial strength to its subsidiary savings associations and shall not conduct its operations in an unsafe or unsound manner.”<sup>11</sup>

Additionally, Regulation LL (12 C.F.R. 238.8(a)(2)) specifies that if the Board believes an activity of the SLHC or a nonbank subsidiary constitutes a serious risk to the financial safety, soundness, or stability of a subsidiary savings association and is inconsistent with the principles of sound banking, the purposes of HOLA or other applicable statutes, the Board may require the SLHC to terminate the activity or divest control of the nonbanking subsidiary. This obligation is established in section 10(g)(5) of HOLA; BHCs are subject to equivalent obligations under the BHC Act and Regulation Y.

1020.0.3.2 Regulation MM

Regulation MM (12 C.F.R. part 239) sets forth regulations governing SLHCs in mutual form (mutual savings and loan holding companies or mutual SLHCs). Regulation MM

- regulates the reorganization of mutual savings associations to mutual holding companies and the creation of subsidiary holding companies of mutual holding companies,
- defines and regulates the operations of mutual holding companies and their subsidiary holding companies, and
- sets forth procedures for securing approval for these transactions.

1020.0.3.3 Regulation Q

In 2013, the Federal Reserve Board, the FDIC, and the OCC adopted Regulation Q (12 C.F.R. part 217) to replace their general risk-based capital requirements, advanced approaches capital requirements, market risk capital requirements, and leverage capital requirements. Regulation Q implements certain federal laws related to capital requirements and international regulatory capital standards adopted by the Basel Committee on Banking Supervision. Regula-

7. 12 C.F.R. 238.170.  
8. 12 C.F.R. 238.10.  
9. Public Law 115–174, 132 Stat. 1296 (2018). SLHCs significantly engaged in insurance activities are generally exempt from most of these requirements.  
10. For more information, see this manual’s section 2010.0, entitled “Supervision of Subsidiaries,” specifically subsection 2010.0.1, entitled “Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks.”

11. 12 C.F.R. 238.8(a)(1).

tion Q applies, on a consolidated basis, to every Board-regulated institution that is

- a state member bank;
- a BHC domiciled in the United States that is not subject to 12 C.F.R. part 225, appendix C;<sup>12</sup> or
- a covered SLHC domiciled in the United States.

Regulation Q does not apply to SLHCs substantially engaged in insurance underwriting or commercial activities, or to SLHCs that are insurance underwriting companies. For more information, see section 3000.1, entitled “Assessment of Capital Adequacy,” in the *Commercial Bank Examination Manual*, as well as section 1060.1, entitled “Large Financial Institution Rating System: Capital Planning and Positions,” in this manual.

#### 1020.0.3.4 Applicable Guidance to SLHCs

As with BHCs, the objective of SLHC supervision is to ensure that a holding company acts as a source of strength for its depository subsidiaries, and that it and its nondepository subsidiaries operate in a safe-and-sound manner and in compliance with banking laws. The Board typically issues supervisory guidance through SR letters, which provide further information on the Federal Reserve’s supervisory priorities and practices consistent with the Board’s expectations for condition, performance, and activities of supervised financial institutions. Many SR let-

ters have been issued to describe the Federal Reserve’s consolidated supervision program for BHCs.

In 2014, the Federal Reserve identified SR letters issued prior to July 21, 2011 (the date of transfer of supervision and regulation of SLHCs from the former OTS to the Federal Reserve Board) that are applicable to SLHCs.<sup>13</sup> In establishing its SLHC supervision program, the Federal Reserve, to the greatest extent possible, considered the unique characteristics of SLHCs in the decision to apply an SR letter to SLHCs. The guidance identified in [SR-14-9](#) illustrates practices consistent with Federal Reserve supervisory expectations of SLHCs on a consolidated basis. In general, guidance that was issued after the 2011 transfer date notes whether it applies to the supervision of SLHCs.

#### 1020.0.4 GENERAL SUPERVISORY APPROACH IN ASSESSING SLHCS

As with BHCs, the objective of SLHC supervision is to ensure that a holding company and its nondepository subsidiaries operate in a safe-and-sound manner and in compliance with banking laws. Further, the Board assesses whether an SLHC and its nondepository subsidiaries can serve as a source of strength for, and do not threaten the soundness of, its subsidiary depository institution(s). Federal Reserve supervisory staff also assess whether an SLHC, its subsidiary depository institution(s), and nondepository subsidiaries are in compliance with any enforcement actions, applications commitments, or other supervisory directives. If Federal Reserve supervisory staff concludes that an SLHC is not conducting its operations in a safe-and-sound manner; is in violation of applicable law or regulations; or is not complying with any outstanding enforcement action, commitment, or supervisory directive, or if the primary regulator of a subsidiary savings association has determined that it is not in satisfactory condition, appropriate action is taken against the SLHC, including possible enforcement actions.

The Board has a long-standing policy of supervising BHCs on a consolidated basis, which is also applicable to the supervision of SLHC. Consolidated supervision encompasses all legal

12. 12 C.F.R. part 225, appendix C is the “Small Bank Holding Company and Savings and Loan Holding Company Policy Statement,” and it applies to BHCs with pro forma consolidated assets of less than \$3 billion that (1) are not engaged in significant nonbanking activities either directly or through a nonbank subsidiary; (2) do not conduct significant off-balance-sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; and (3) do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission. The Board may, in its discretion, exclude any BHC, regardless of asset size, from the policy statement if such action is warranted for supervisory purposes. With some exceptions, the policy statement applies to SLHCs as if they were BHCs (12 C.F.R. 238.8(b)). See this manual’s section 2090.2, entitled “Control and Ownership (BHC Formations),” for more information on the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement. The Board may, by order, apply any or all of Regulation Q to any BHC, based on an institution’s asset size, level of complexity, risk profile, scope of operations, or financial condition.

13. See [SR-14-9](#), “Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program.”

entities within a holding company structure and supports an understanding of the organization's complete risk profile and its ability to address financial, managerial, operational, or other deficiencies before they pose a danger to its subsidiary depository institution(s).

In the supervision of BHCs and SLHCs, Federal Reserve examiners rely on the work of the regulators of insured depository institution (IDI) subsidiaries. The principle of relying on the work of the IDI regulators is a well-established tenet of Federal Reserve supervisory policy and is required by statute.<sup>14</sup> BHC and SLHC supervision focuses on the Federal Reserve's assessment of the consolidated organization based on a review of parent and nonbank activities, together with an assessment of the organization's IDI subsidiaries. When assigning Federal Reserve supervisory ratings to BHCs and SLHCs where the Federal Reserve is not the IDI regulator, the Federal Reserve will rely, to the fullest extent possible, on the assessment of the IDI as reflected in the examination work performed by the IDI regulator(s). For more information, see [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."

#### 1020.0.4.1 Supervisory Portfolios and Types of SLHCs

The population of SLHCs is diverse in size, complexity, geographic footprint, and activities. A limited number of SLHCs primarily engage in insurance, broker-dealer, or commercial activities, and, as such, have varying supervision requirements.

An important aspect of the Federal Reserve's consolidated supervision programs is the assessment and evaluation of practices across groups of organizations with similar characteristics and risk profiles. This "portfolio approach" to consolidated supervision facilitates greater consistency of supervisory practices and assessments across comparable organizations and enhances the Federal Reserve's ability to identify outlier organizations among established peer groups.

In general, the Federal Reserve's supervisory program for an SLHC engaged primarily in depository institution activities conducted through its savings association(s) is based on the Federal Reserve's supervisory program for portfolios of BHCs of similar asset size and complexity. Specifically, such an SLHC is treated as a community, regional, or large banking organization from a supervisory perspective.<sup>15</sup> In addition, the Federal Reserve considers any unique characteristics of SLHCs and the requirements of HOLA to assess the condition, performance, and activities of SLHCs on a consolidated basis in a manner that is consistent with the Board's established risk-based approach regarding BHC supervision.

A limited number of SLHCs are primarily engaged in commercial, insurance, and broker-dealer activities. Given the distinct nature of these entities, the Board generally supervises these entities outside of the traditional BHC portfolio approach, which is based largely upon asset size.

Certain SLHCs were permitted to engage in commercial activities through the exemption in section 10(c)(9)(C) of HOLA, or are primarily engaged in activities that were authorized by regulation on March 5, 1987, for SLHCs to engage in directly, and have savings association subsidiaries that account for only a small percentage of the total consolidated assets of the SLHC. Commercial SLHCs are principally engaged either in commercial activities (such as manufacturing or merchandising) or in activities not specifically permissible for financial holding companies (such as real estate development).<sup>16</sup> For SLHCs engaged in commercial activities, the segregation of the financial business lines of these companies will vary and some or all corporate functions may integrate both commercial and financial business lines. Inspections of such companies include functions that directly relate to financial activities, such as risk management, corporate governance, and internal financial activities (e.g., treasury functions, derivative/hedging transactions, or lending). Examiners also assess commercial activities only to the extent that these activities may impact the savings association subsidiary(ies), including the holding company's ability to serve as a source of strength to them.

14. Refer to sections 5(c)(1)–(2) of the BHC Act and sections 10(b)(2) and (b)(4) of the HOLA, as amended by section 604 of the Dodd-Frank Act. 12 U.S.C. 1844(c)(1)–(2); 12 U.S.C. 1467a(b)(2), (b)(4).

15. For more information, see the "[Community & Regional Financial Institutions](#)" page and the "[Large Financial Institutions](#)" page on the Board's public website.

16. Section 10(c)(9)(C) of HOLA permitted certain SLHCs, referred to as legacy unitary SLHCs, to retain their authority to engage in nonfinancial activities. 12 U.S.C. § 1467a(c)(9)(C).

In general, SLHCs are considered insurance SLHCs if they are an insurance underwriting company or if 25 percent or more of their total consolidated assets are in subsidiaries that are insurance underwriting companies. The risks arising from insurance activities are materially different from traditional banking risks. Additionally, instead of producing consolidated financial statements based on generally accepted accounting principles, some of these firms only produce legal entity financial statements based on Statutory Accounting Principles (SAP) established by states through the National Association of Insurance Commissioners (NAIC).

The top-tier holding company for some supervised insurance SLHCs is an insurance underwriting company, which is subject to supervision and regulation by the relevant state insurance regulator as well as consolidated supervision from the Board. For all insurance SLHCs, the state insurance regulators supervise and regulate the business of insurance. Much like the assessment of BHCs, examiners responsible for the supervision of insurance SLHCs rely, to the fullest extent possible, on the work of an insurance SLHC's state insurance regulator(s) and factor this work, as well as the insurance SLHC's Own Risk and Solvency Assessment (ORSA) into their consolidated assessment. Inspection activities are also commensurate with, and proportional to, the scope, complexity, and size of the insurance SLHC's risk profile.

#### 1020.0.4.2 Assignment of Supervisory Ratings

##### *CORE Rating System*

Prior to the transfer of supervisory responsibility for SLHCs to the Federal Reserve, the OTS assigned supervisory ratings for SLHCs under the CORE rating system. Under the CORE rating system, SLHCs generally were assigned individual component ratings for capital (C), organizational structure (O), risk management (R), and earnings (E), as well as a composite rating that reflected an overall assessment of the holding company as reflected by consolidated risk management and financial strength.

##### *Indicative RFI Ratings*

In 2011, the Board began transitioning SLHCs to the Board's "RFI/C(D)" rating system (commonly referred to as "RFI"), applicable to BHCs.

The Federal Reserve decided to issue "indicative RFI ratings" to SLHCs until such time that a rating system was formally adopted for these companies.<sup>17</sup> Indicative ratings were issued to SLHCs as a way of providing feedback to SLHCs regarding their performance relative to supervisory expectations. Further, indicative ratings described how the SLHC would be rated under the RFI rating system if applied to the company. Similar to traditional inspections, the findings accompanying the indicative rating included detailed descriptions of deficiencies that need to be addressed by management and/or the board of directors.

The Board continues to assign indicative ratings under the RFI rating system to SLHCs that derive 50 percent or more of their total consolidated assets or total revenues from activities that are not financial in nature under section 4(k) of the BHC Act, as amended (12 U.S.C. 1843(k)) (commercial SLHCs). For SLHCs that continue to receive an indicative rating under the RFI rating system, examiners consider the risks inherent in the SLHC's activities and the ability of capital to absorb unanticipated losses, provide a base for growth, and support the level and composition of the parent company and subsidiaries' debt in the evaluation of the SLHC's capital adequacy.

##### *Assignment of RFI Ratings*

In November 2018, the Federal Reserve adopted a final rule to apply the RFI rating system on a fully implemented basis to SLHCs with total consolidated assets less than \$100 billion, excluding SLHCs engaged in significant insurance or commercial activities.<sup>18</sup> Because the vast majority of SLHCs face similar risks and engage largely in the same activities as BHCs, the Board sought to apply the same RFI rating system to SLHCs (rather than the CORE rating system) as the Board currently applies to BHCs to promote consistency.

The Federal Reserve modified the applicability of the RFI rating system, which was initially developed in 2004, to cover non-insurance and non-commercial SLHCs with total consolidated assets less than \$100 billion. Examination staff

17. For more information on the RFI rating system, see [SR-19-4/CA-19-3](#), "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than \$100 billion," and this manual's section 1062.0, "RFI Rating System."

18. See 83 Fed. Reg. 56,081 (November 7, 2018).

assign and communicate ratings to BHCs and non-insurance and non-commercial SLHCs with total consolidated assets between \$10 billion and \$100 billion on at least an annual basis, and more frequently as warranted.

The scope and frequency of inspections of BHCs and non-insurance and non-commercial SLHCs with less than \$10 billion in total consolidated assets is dependent on a number of factors such as the asset size, rating and examination cycle of the holding company's subsidiary depository institution, and the complexity of the holding company. For example, noncomplex holding companies with total consolidated assets less than \$3 billion only receive a composite rating and risk management rating to the holding company based on the ratings of the lead depository institution. For more information, see [SR-13-21](#), "Inspection Frequency and Scope Expectations for Bank Holding Companies and Savings and Loan Holding Companies that are Community Banking Organizations" and section 1045.1 of this manual.

*Large Financial Institutions Rating System*

In 2019, the Federal Reserve began to implement the large financial institution (LFI) rating system.<sup>19</sup> Federal Reserve supervisory staff use this rating system to evaluate and communicate the supervisory condition of

- BHCs with total consolidated assets of \$100 billion or more;
- U.S. intermediate holding companies of foreign banking organizations with combined U.S. assets of \$50 billion or more, established pursuant to the Federal Reserve's Regulation YY; and
- all non-insurance, non-commercial SLHCs with total consolidated assets of \$100 billion or more.

For more information on the assignment of LFI ratings to BHCs and SLHCs, see this manual's section 1060.0, entitled "Large Financial Institution Rating System," as well as [SR-19-3/CA-19-2](#), "Large Financial Institution (LFI) Rating System."

Regulation LL restricts SLHCs from commencing certain activities without the Federal

Reserve's prior approval unless the company received a composite rating of 1 or 2 at its most recent examination.<sup>20</sup> After the issuance of the LFI ratings system, the Federal Reserve amended regulatory provisions so that they will apply to entities that receive numerical composite ratings, as well as to entities that do not receive numerical composite ratings (including firms subject to the LFI rating system). To be considered satisfactory, an SLHC under the LFI ratings system would have to be rated "Broadly Meets Expectations" or "Conditionally Meets Expectations" for each component of the LFI rating system. An SLHC rated "Deficient-1" or lower for any component would not be considered satisfactory. This standard applies to any provision contained in the Federal Reserve's regulations, which requires or refers to a firm having a satisfactory composite rating.

*Supervisory Framework and Rating System for Insurance Organizations*

In September 2022, the Federal Reserve issued a framework describing the consolidated supervision of supervised insurance organizations. See [SR-22-8](#), "Framework for the Supervision of Insurance Organizations."<sup>21</sup> The framework addresses Federal Reserve supervisory expectations for insurance organizations that are overseen by the Board, including

- *Proportional application of supervisory guidance, resources, and activities:* how supervised insurance organizations are categorized as either complex or noncomplex based on risk profile, how the application of supervisory guidance is risk-based, and how supervisory resources are assigned and supervisory activities are conducted.
- *Supervised insurance organization ratings:* the ratings system applied to supervised insurance organizations, including the component ratings and rating definitions. Federal Reserve examiners periodically assign one of four ratings (Broadly Meets Expectations, Condition-

20. 12 C.F.R. 238.54(a)(1).

21. See also 87 Fed. Reg. 60,160 (October 4, 2022). At the time the framework was established all supervised insurance organizations were savings and loan holding companies. However, the framework applies to any depository institution holding company that meets the criteria of a "supervised insurance organization." A "supervised insurance organization" is a depository institution holding company that is an insurance underwriting company, or that has over 25 percent of its consolidated assets held by insurance underwriting subsidiaries, or has been otherwise designated as a supervised insurance organization by Federal Reserve staff.

19. [SR-19-3/CA-19-2](#), "Large Financial Institution (LFI) Rating System."

ally Meets Expectations, Deficient-1, and Deficient-2) to each of the three rating components (Capital Management, Liquidity Management, and Governance & Controls) used to assess supervised insurance organizations.<sup>22</sup>

- *Incorporating the work of other supervisors:* Similar to the approach taken by the Federal Reserve in its consolidated supervision of other firms, the oversight of supervised insurance organizations relies, to the fullest extent possible, on work performed by other relevant supervisors.

## 1020.0.5 SPECIFIC ISSUES RELATED TO THE SUPERVISION OF SLHCS

### 1020.0.5.1 Qualified Thrift Lender and the Qualified Thrift Lender Test

SR-17-9, “Supervisory Guidance for Examining Compliance with the Qualified Thrift Lender Test,” provides supervisory guidance regarding the Qualified Thrift Lender (QTL) test under section 10(m) of HOLA.<sup>23</sup> Section 10(l) of HOLA permits a state savings bank or insured cooperative bank (referred to as an “electing bank”) that meets the QTL test to be deemed a savings association solely for the purpose of determining the status of the electing bank’s parent holding company as a SLHC under section 10 of HOLA.<sup>24</sup> Further, SR-17-9 provides an overview of the Federal Reserve’s QTL requirements and the consequences of failing the QTL test for electing banks that are members of the Federal Reserve System and their parent holding companies.

SR-17-9 also outlines procedures examiners should consider when assessing an institution’s QTL compliance program. The purpose of these procedures is to help examiners determine whether an electing bank meets the QTL test under section 10(m) of HOLA<sup>25</sup> and has a satisfactory process to ensure ongoing compliance with the QTL test. The examination procedures in SR-17-9 are applicable only to electing banks

in which the Federal Reserve has responsibility for assessing QTL compliance.

### 1020.0.5.2 Covered Savings Associations

Section 206 of EGRRCPA created a new section 5A in HOLA, which requires the OCC to issue regulations to allow certain federal savings associations to elect to operate as covered savings associations (CSAs).<sup>26</sup> CSAs have the same rights and privileges, and are subject to the same duties, restrictions, penalties, liabilities, conditions, and limitations as a national bank that has its main office in the same location as the home office of the CSA.<sup>27</sup> A CSA is therefore not required to comply with the lending limits established by HOLA and is not directly subject to penalties for failing to remain a QTL.<sup>28</sup> However, CSAs continue to be treated as federal savings associations for some purposes, including governance, incorporation, bylaws, boards of directors, shareholders, mutual members, and distribution of dividends; and consolidation, merger, dissolution, conversion (including conversion to a stock bank or another charter), conservatorship, and receivership.<sup>29</sup>

### *Applicability Considerations*

Eligible federal savings associations may make an election to operate as CSAs any time on or after July 1, 2019. To qualify as a CSA, a federal savings association must have

1. existed on December 31, 2017, and
2. had \$20 billion or less in total assets as reported on its December 31, 2017, Call Report.<sup>30</sup>

Under the first qualification prong, an institution that was a credit union, state savings association, or state bank on December 31, 2017, but later converted to a federal savings association charter, would not be eligible to make an election to operate as a CSA.<sup>31</sup>

26. Public Law 115–174, 132 Stat. 1310; 12 U.S.C. 1464a.

27. 12 U.S.C. § 1464a(c); 12 C.F.R. 101.4(a)(1).

28. See 84 Fed. Reg. 23,991 (May 24, 2019).

29. 12 U.S.C. § 1464a(d); 12 C.F.R. 101.4(a)(2).

30. 12 U.S.C. § 1464a(1); 12 C.F.R. 101.3(a)(1).

31. See *Frequently Asked Questions: Implementation of Covered Savings Association Final Rule*, Office of the Comptroller of the Currency, OCC 2019-31 (July 2019), at 5 (“OCC FAQs”).

22. To be considered “well managed,” a firm must receive a rating of “Conditionally Meets Expectations” or better in each of the three rating components. Each rating is defined specifically for supervised insurance organizations with particular emphasis on the obligation that firms serve as a source of financial and managerial strength for their depository institution(s).

23. 12 U.S.C. 1467a(m).

24. 12 U.S.C. 1467a(l).

25. 12 U.S.C. 1467a(m)(1).

Concerning the second qualification prong, a federal savings association that successfully becomes a CSA will continue to be treated as a CSA even if its total consolidated assets exceed \$20 billion after it makes an election.<sup>32</sup> Unlike attaining financial holding company status for BHCs or SLHCs, the financial and managerial condition, as communicated via supervisory ratings, does not affect a federal savings association’s ability to make an election or to continue to operate as a CSA after making an election.<sup>33</sup>

*Federal Reserve Legal Interpretations of CSAs and Holding Companies over CSAs*

The Federal Reserve Act does not address the treatment of CSAs for purposes of compliance with the affiliate transaction rules in sections 23A and 23B of the Federal Reserve Act (as implemented by the Board’s Regulation W,

12 C.F.R. part 223) or membership in the Federal Reserve System (12 C.F.R. part 208). On April 1, 2021, the Federal Reserve published legal interpretations regarding the treatment of CSAs, clarifying that a CSA is subject to the same requirements regarding membership in the Federal Reserve System and the same prohibitions on affiliate transactions, under sections 23A and 23B of the Federal Reserve Act, as a national bank.<sup>34</sup>

The BHC Act, HOLA, and EGRRCPA also do not address the treatment of holding companies that control a CSA. Board staff interprets section 5A of HOLA as requiring the holding company of a CSA to be treated as a BHC, rather than as a SLHC. The Board has published a series of frequently asked questions (FAQs) to assist CSAs and companies that control a CSA in complying with statutes and regulations administered by the Board.<sup>35</sup>

32. 12 U.S.C. § 1464a(g); 12 C.F.R. 101.4(c).  
33. See OCC FAQs, *supra* note 38, at 4–5.

34. See [Letter from Mark Van Der Weide, General Counsel of the Board, to Trisha L. Kalscheur, April 1, 2021](#).  
35. See, [SR-22-2](#), “Status of Covered Savings Associations and Holding Companies of Covered Savings Associations Under Statutes and Regulations Administered by the Federal Reserve”; and [Frequently Asked Questions about Covered Savings Associations Pursuant to Section 5A of the Home Owners’ Loan Act](#).

# Bank Holding Company Examination and Inspection Authority

## Section 1040.0

### WHAT'S NEW IN THIS REVISED SECTION

*Effective July 2012, this section has been revised to discuss the current authority for the Federal Reserve (FR) to conduct BHC inspections (examinations) under section 5(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1844(c)) and also 12 U.S.C. 5361(a)–(c). The section also is revised to include provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (section 604(c)(2)), which removed the enforcement provisions of section 10A of the Bank Holding Company Act that limited the FR's rulemaking and enforcement authority. Previously, the FR was only able to take enforcement actions against a functionally regulated subsidiary when its actions posed a threat to the safety and soundness of a depository institution affiliate.*

#### 1040.0.1 BHC INSPECTIONS

The Gramm-Leach-Bliley Act (GLB Act) amended section 5(c) of the Bank Holding Company Act (BHC Act) pertaining to BHC reports and examinations (or inspections, in the case of BHCs). The GLB Act provides specific supervisory guidance to the Board of Governors (Board) of the Federal Reserve System (and the Federal Reserve Banks via delegated authority) with respect to the breadth of BHC inspections. It also emphasized the focus and scope of BHC inspections and the inspections of BHC subsidiaries. An inspection is to be conducted to—

1. inform the board of the nature of the operations and financial condition of each BHC and its subsidiaries, including—
  - a. the financial and operational risks within the holding company system that may pose a threat to the safety and soundness of any depository institution (DI) subsidiary of such bank holding company, and
  - b. the systems for monitoring and controlling such financial and operational risks; and
2. monitor compliance by any entity with the provisions of the BHC Act or any other federal law that the Board has specific jurisdiction to enforce against the entity, and to monitor compliance with any provisions of federal law governing transactions and relationships between any DI subsidiary of a BHC and its affiliates.

#### 1040.0.1.1 Authority for Bank Holding Company Inspections

Section 5 of the BHC Act of 1956 authorizes the Board to require reports and to conduct inspections of bank holding companies and their affiliates.<sup>1</sup> Subject to the limitations discussed below, Section 5 authorizes the Board to examine each bank holding company and nonbank subsidiary thereof. Within those limitations, the Federal Reserve System's supervisory staff (includes BHC inspection and examination staff) may review *all* books and records of a banking organization that is subject to Federal Reserve (FR) supervision.<sup>2</sup>

#### 1040.0.2 FOCUS AND SCOPE OF BHC INSPECTIONS

The focus and scope of an inspection is to be limited, to the fullest extent possible, to the BHC and any subsidiary of the BHC that could have a materially adverse effect on the safety and soundness of any DI subsidiary of the holding company due to (1) the size, condition, or activities of the subsidiary, or (2) the nature or size of the transactions between the subsidiary and any DI subsidiary of the BHC.

The Board is to use, to the fullest extent possible, the bank examination reports of DIs prepared by the appropriate federal or state DI supervisory authority. The Board also is to use, to the fullest extent possible, the examination reports for non-DIs prepared by the following:

1. the Securities and Exchange Commission (SEC) for any registered broker or dealer
2. the SEC or any state for any investment adviser registered under the Investment Company Act of 1940
3. any state insurance regulatory authority for any licensed insurance company
4. any federal or state authority for any other subsidiary that the Board finds to be comprehensively supervised

1. See 12 U.S.C. 1844.

2. Supervisory staff includes individuals that are on and/or off site.

### 1040.0.3 EXAMINATIONS OF FUNCTIONALLY REGULATED SUBSIDIARIES

In general, the Board may examine (inspect) any BHC and each subsidiary to inform the Board of

- the nature of the operations and financial condition of the company and such subsidiary;
- the financial, operational, and other risks of the company or such subsidiary that may pose a threat to the safety and soundness of such company or subsidiary or to the financial stability of the United States;
- the systems for monitoring and controlling such risks; and
- compliance by the company or such subsidiary with the requirements of 12 U.S.C. 5361(b) and other provisions of the BHC Act and certain other federal statutes.

#### 1040.0.3.1 Use of Examination Reports and Information

The Board is required, to the fullest extent possible, to rely on reports of examination of any subsidiary depository institution or functionally regulated subsidiary made by the primary financial regulatory agency for that subsidiary, and on information described for reports under 12 U.S.C. 5361(a)(2). (See 12 U.S.C. 5361(b)(2).)

#### 1040.0.3.2 Coordination with Other Regulators

The Board is to

- provide reasonable notice to, and to consult with, the primary financial regulatory agency for any subsidiary before requiring a report or commencing an examination of such subsidiary under this section; and
- avoid duplication of examination activities, reporting requirements, and requests for information, to the fullest extent possible.

(See 12 U.S.C. 5361(c).)

### 1040.0.4 SUPERVISION OF A NONBANK FINANCIAL COMPANY

The FR, as the appropriate federal supervisory banking agency, must, to the fullest extent possible, rely on (1) reports and other supervisory information that the BHC, or any subsidiary thereof, has been required to provide to other federal and state regulatory agencies; (2) externally audited financial statements of the BHC or subsidiary; (3) information that is otherwise available from federal and state regulatory agencies; and (4) information that is required to be reported publicly. (See 12 U.S.C. 1844(c)(1) or section 5(c) of the BHC Act.)

# Supervision of Holding Companies with Less Than \$10 Billion in Total Consolidated Assets

## Section 1045.0

### 1045.0.1 OVERVIEW AND RELIANCE ON THE INSURED DEPOSITORY INSTITUTION REGULATOR

The Federal Reserve's approach to the supervision of holding companies with less than \$10 billion in total consolidated assets is primarily described in [SR-13-21](#), "Inspection Frequency and Scope Expectations for Bank Holding Companies and Savings and Loan Holding Companies that are Community Banking Organizations." Reserve Banks, in the vast majority of cases, conduct abbreviated off-site reviews of small, noncomplex holding companies with total consolidated assets of up to \$3 billion upon receipt of examination reports from the insured depository institution (IDI) regulator of the lead subsidiary IDI.

These Reserve Bank reviews assess activities conducted outside of the subsidiary IDI and rely substantially on the findings of the IDI regulator to evaluate the overall condition of the institution. For larger holding companies in the community banking organization (CBO) supervision portfolio, Reserve Banks conduct point-in-time on- or off-site reviews that are coordinated with, or closely follow, onsite examinations of the lead subsidiary IDI by its IDI regulator. The Reserve Bank reviews of larger CBO holding companies are targeted toward assessing parent company and nonbank activities and their potential effect on the safety and soundness of the subsidiary IDI.

The Reserve Bank evaluates the condition, performance, and prospects of the subsidiary IDI based on the conclusions of the IDI regulator and makes best efforts not to duplicate the work of other prudential regulators. Refer to [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."

The Federal Reserve relies on periodic on- and off-site inspections to assess the safety and soundness of supervised bank holding companies (BHCs) and savings and loan holding companies (SLHCs) (collectively referred to as "holding companies"). The guidance in [SR-13-21](#) outlines the minimum inspection frequency and scope expectations for supervised holding companies with less than \$10 billion in total consolidated assets to

- conform inspection frequency and scope expectations for SLHCs with less than \$10 billion in total consolidated assets to those applicable to BHCs of the same size;
- clarify the scoping expectations for targeted inspections conducted at holding companies with total consolidated assets of at least \$3 billion but less than \$10 billion; and
- modify the expectations for targeted inspections for "3," "4," and "5"-rated holding companies with total consolidated assets of at least \$3 billion but less than \$10 billion.

These frequency and scope expectations vary depending on whether a holding company has been designated as "complex," with more complex holding companies subject to more frequent and in-depth review. If needed for supervisory purposes, Reserve Banks may inspect a holding company with greater frequency and scope.

### 1045.0.2 DEFINITION OF COMPLEX HOLDING COMPANIES

The determination of whether a holding company is "complex" should be made at least annually by the responsible Reserve Bank. Utilizing surveillance screens and other information obtained through supervisory or applications processes, Reserve Banks should update the complexity designation of a company as its activities or condition changes. The determination of a holding company's complexity should take into account a number of factors. These factors include the

- size and structure of the company;
- the extent of intercompany transactions between IDI subsidiaries and the holding company or uninsured subsidiaries of the holding company;
- the risk, scale, and complexity of activities of any nondepository subsidiaries;<sup>1</sup> and

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1. For SLHCs, consideration should be given to whether the holding company is a legacy unitary SLHC, and if so, the type and extent of the activities in which the company engages. Guidance on ratings, examination frequency, and complexity classifications for supervised insurance organizations is available in [SR-22-8](#), "Framework for the Supervision of Insurance Organizations."

- the degree of leverage at the holding company, including the extent of its debt outstanding to the public.

Companies should also be designated “complex” if material risk-management processes for the holding company and its affiliates are consolidated at the parent company.

1045.0.3 SUPERVISION AND SURVEILLANCE APPROACH

The frequency and scope of on- and off-site inspections should be adjusted based on the results of examinations of a company’s depository institution subsidiaries and off-site surveillance. Whether the inspection is conducted on- or off-site will depend on the level and nature of the risks involved, the holding company’s ability to manage those risks, and the Reserve Bank’s ability to acquire the necessary information to analyze the activity off-site. If information obtained off-site is not sufficient for the Reserve Bank to determine the condition or assess the activity of the company to assign a rating, the Reserve Bank should conduct an on-site inspection (full-scope or targeted, as appropriate).

To facilitate prompt follow-up on changes in a company’s performance and condition, the Federal Reserve maintains distinct surveillance programs for small holding companies (less than \$3 billion in total consolidated assets) and larger holding companies. Surveillance screens for holding companies with \$3 billion or more in total consolidated assets focus on identifying those companies reporting financial results that seem to be inconsistent with their current supervisory ratings, as well as activities conducted outside of depository institution subsidiaries. For small holding companies, surveillance screens focus on the identification of potential parent company and nondepository subsidiary issues that may adversely affect affiliated depository institutions. In particular, these screens address parent company cash flow, intercompany transactions, parent company leverage, and consolidated capital ratios, when applicable. Screens also assist in maintaining up-to-date complexity designations and are updated periodically to reflect industry trends and conditions as well as changes in regulatory reporting requirements.

1045.0.4 FREQUENCY AND SCOPE OF INSPECTIONS OF HOLDING COMPANIES WITH TOTAL CONSOLIDATED ASSETS OF AT LEAST \$3 BILLION BUT LESS THAN \$10 BILLION

Complex holding companies in satisfactory condition are inspected at least once per calendar year, while noncomplex holding companies may be inspected every other year. The Reserve Banks should attempt to conduct inspections of holding companies with at least \$3 billion but less than \$10 billion in total consolidated assets shortly after the examination of the lead depository subsidiary is completed. These holding companies are assigned a complete RFI rating (component ratings, subcomponent ratings, and a composite rating) regardless of their complexity.<sup>2</sup>

Depending on their condition and complexity, holding companies in this category will receive full-scope inspections or targeted inspections. At a minimum, a full-scope inspection should include sufficient procedures to reach an informed judgment regarding the assigned ratings for the factors addressed by the RFI rating system, evaluating the organization’s methods of managing and controlling its risk exposures, and ascertaining whether management and directors fully understand and are actively monitoring the organization’s exposure to those risks.

A targeted inspection is designed to focus intensively on one or more specific areas, activities, or problems relating to a holding company. Targeted inspections of holding companies with total consolidated assets of at least \$3 billion but less than \$10 billion should focus primarily on parent company leverage, parent company cash flow, nondepository subsidiaries, consolidated capital (when applicable), and intercompany transactions. Targeted inspections may also cover other applicable areas, such as deficient risk-management practices at the holding company.

In addition, because compliance with laws and regulations is a statutory factor that must be considered as part of any supervisory review of an application or notice by a holding company, it is important that Reserve Bank staff ensure that compliance with relevant laws and regulations, including any commitments provided by a holding company in connection with an application or notice, is evaluated and addressed in written inspection reports.

2. See [SR-19-4/CA-19-3](#), “Supervisory Rating Systems for Holding Companies with Consolidated Assets Less Than \$100 billion,” and section 1062.0 of this manual.

*1045.0.4.1 Complex Holding Companies*

- If a complex holding company is rated composite “1” or “2,” a full-scope, on-site inspection should be completed annually.
- The following apply for a complex holding company rated composite “3,” “4,” or “5.”
  - A full-scope, on-site inspection should be completed annually.
  - If the primary supervisor has conducted an interim examination or changed the rating at the lead depository institution, Reserve Bank staff should conduct an additional targeted inspection and update the holding company rating if necessary. The targeted inspection may be conducted off-site and should start within 60 days of receiving the examination report for the lead depository institution.
- Interim inspections between regular full-scope, on-site inspections are not required. However, additional follow-up, including interim inspections, may be necessary in response to off-site surveillance program results.

*1045.0.4.2 Noncomplex Holding Companies*

- If a noncomplex holding company is rated composite “1” or “2,” an off-site targeted inspection should be completed every two years.
- The following apply for a noncomplex holding company rated composite “3,” “4,” or “5.”
  - A full-scope, off-site inspection should be completed annually.
  - If the primary supervisor has conducted an interim examination or changed the rating at the lead depository institution, Reserve Bank staff should conduct an additional targeted inspection and update the holding company rating if necessary. This targeted inspection may be conducted off-site and should start within 60 days of receiving the examination report for the lead depository institution.
- Interim inspections between regular full-scope inspections are not required. However, additional follow-up, including interim inspections, may be necessary in response to off-site surveillance program results.

**1045.0.5 FREQUENCY AND SCOPE OF REVIEW OF HOLDING COMPANIES WITH LESS THAN \$3 BILLION IN TOTAL CONSOLIDATED ASSETS**

The supervisory cycle for holding companies with less than \$3 billion in total consolidated assets generally is determined by the examination frequency of the lead depository institution. Complex companies in this size category are assigned a complete RFI rating; others are assigned only a risk-management rating and a composite rating. All ratings assigned should be promptly entered into the National Examination Database (NED) and communicated to the company, Board staff, and appropriate state and federal regulatory authorities as soon as possible, but generally no later than 90 days after receipt of the lead depository institution examination report.

Although an off-site review of small holding companies will be appropriate in many cases, in some instances it may be necessary to conduct an on-site review for complex holding companies, as discussed below. In those cases when an on-site review is expected, the findings of that review and the assigned ratings should be communicated to the company no later than 120 days after receipt of the lead depository institution examination report. Documentation for the ratings and off-site or on-site reviews will generally consist of the examination reports for the depository institution subsidiaries, a copy of the transmittal letter communicating the ratings to the company, information related to relevant System surveillance results, and memoranda supporting any on-site review conducted. A meeting between Reserve Bank staff and the company’s board of directors to communicate findings is not required, but should be conducted when warranted by supervisory concerns.

*1045.0.5.1 Complex Holding Companies*

- An off-site review should be conducted upon receipt of the lead depository institution examination report or an updated rating from the primary supervisor using surveillance results and relevant supervisory and financial information. If the information obtained off-site is not sufficient for the Reserve Bank to determine the overall condition of the company

- and to assign a complete RFI rating, the Reserve Bank should conduct an on-site review of the company.
- Any on-site review should be targeted at those areas where additional information or analysis is needed to assign a complete supervisory rating.

1045.0.5.2 *Noncomplex Holding Companies*

- If all subsidiary depository institutions have a management component rating and a composite supervisory rating of “1” or “2” and no material holding company issues are otherwise indicated, the Reserve Bank should assign only a composite rating and risk management rating to the holding company based on the ratings of the lead depository institution.
- If one or more subsidiary depository institutions have a management component rating or a composite supervisory rating of “3,” “4,” or “5” or a material holding company issue is otherwise indicated, an off-site review should be completed upon receipt of the lead depository institution examination report or an updated rating from the primary supervisor using surveillance results and relevant supervisory and financial information. If the information obtained off-site is not sufficient for the Reserve Bank to determine the overall condition of the company and to assign a risk-management rating and a composite rating, Reserve Bank staff should contact the holding company to obtain more information.
- Any off-site review should be targeted, as appropriate, at those areas where additional information or analysis is needed to develop the risk-management and composite ratings.

1045.0.6 INSPECTION REPORT CONTENT FOR CBO HOLDING COMPANIES

1045.0.6.1 *Inspection Report Content for Small Noncomplex Holding Companies*

As noted above, the supervisory cycle for noncomplex holding companies with less than \$3 billion in total consolidated assets (“small noncomplex holding companies”) generally is determined by the examination frequency of the lead IDI

subsidiary. Small noncomplex holding companies are assigned a risk-management rating and a composite rating from the RFI/C(D) rating system. Furthermore, Federal Reserve examiners rely on the primary regulator’s work on the subsidiary IDI.<sup>3</sup> At small noncomplex holding companies, Federal Reserve examination staff focus their review at the parent holding company and any nonbanking activities.

When a small noncomplex holding company’s subsidiary depository institution(s) has a management component rating and a composite CAMELS rating of “1” or “2” and no material holding company issues are otherwise indicated, the holding company ratings are based primarily on the ratings of the lead depository institution. As such, reports of inspection for these holding companies are developed primarily to briefly convey the risk-management rating and a composite rating. However, if there are supervisory issues at the subsidiary bank or small noncomplex holding company, the inspection report will convey additional information as appropriate.

Below is a summary of content that is included in inspection reports for small noncomplex holding companies.

All reports will contain the following information:

- *Ratings Assigned:* The report will state the numerical risk management and composite rating of the holding company. A brief qualitative description of the ratings assigned will also be provided in the report. For more information on the RFI/C(D) rating system, including ratings definitions, see section 1062.0.
- *Confidential Supervisory Information:* The report will note that the contents contain confidential supervisory information and that the Board has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in statute (12 U.S.C. 1817(a) and 1831m) and implementing regulations (12 CFR part 261, subpart C). This information may be conveyed on a report cover sheet or in a footnote reference in the report of inspection.
- *Standard Appeals Language:* The report will contain standard language in a footnote noting that any institution about which the Federal Reserve makes a written material supervisory

3. Several states have holding company supervisory authority and may issue ratings for small noncomplex holding companies. Examiners should rely on the review of a holding company conducted by a state agency to the extent that the scope of the review is consistent with the Federal Reserve’s objectives in holding company supervision.

determination is eligible to utilize the appeals process as described in the Appeals Process and Board Ombudsman (Ombuds) Policy Statement. For more information, see 85 Fed. Reg. 15,175 (March 17, 2020) as well as [SR-20-28/CA-20-14](#), “Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System.”

- *Key Administrative Information:* This information includes
  - the date the Reserve Bank completed the offsite review,
  - a cross reference to the examination report from the subsidiary IDI that formed the basis of the conclusions in the holding company report of inspection, and
  - Reserve Bank examination staff contact information.

In certain situations, the inspection report for a holding company with a composite rating of “3” or worse would include additional information, as appropriate. Below are some content headings that could appear in the report depending on the circumstances at the holding company:

- *Overall Conclusion:* A discussion about the overall conclusion of the offsite review is included in the inspection report for holding companies rated “3” or worse. The contents of this heading will depend on the specific circumstances, such as multiple depository institution subsidiaries or a material nonbank subsidiary. This section may also be used for 1- or 2-rated companies if the examiner needs to convey a specific message to management.
- *Source of Strength:* The report may include language that a BHC or a SLHC is expected to act as a source of managerial and financial strength to its subsidiary depository institutions.<sup>4</sup> The report will inform holding company management and the board of directors to take steps to conserve assets and other resources for the benefit of the depository institution and keep the Reserve Bank informed of such measures.
- *Matters Requiring Attention:* This language is included in the report when examination staff cite a Matter Requiring Immediate Attention (MRIA) or Matter Requiring Attention (MRA). The definitions of MRIs and MRAs, or references to the guidance defining MRIs and

MRAs, should be included as a footnote in the report.<sup>5</sup> The report should also provide a reference to the Statement Clarifying the Role of Supervisory Guidance.<sup>6</sup>

- *Enforcement Action:* This heading is included in the report if the holding company is under an enforcement action, or is communicating the termination of an enforcement action. Several factors dictate the contents of this heading language, such as
  - action status (initiate, continue, or terminate);
  - type of action (informal actions vs. formal actions);
  - whether the informal action is enclosed in the inspection report or will be communicated in a separate cover; and
  - whether the holding company is in non-compliance with the financial holding company requirements of section 4(1) of the Bank Holding Company Act and is therefore subject to the provision of section 4(m).
- *Troubled Condition:* If the holding company is determined to be in troubled condition, the report will communicate this information to the holding company. The report will also indicate whether the holding company is no longer considered to be in troubled condition. Furthermore, the section will also include references to relevant regulations and guidance, including
  - 12 CFR 225.71 (Regulation Y)
  - 12 CFR 238.72 (Regulation LL)
  - [SR-19-12](#), “Statement Regarding Insurance Policies for Directors and Officers”
  - [SR-03-6](#), “Guidance Regarding Restrictions on Institutions in Troubled Condition”
  - [SR-02-17](#), “Guidance Regarding Indemnification Agreements and Payments”

5. See [SR-13-13/CA-13-10](#), “Supervisory Considerations for the Communication of Supervisory Findings.”

6. The “Statement Clarifying the Role of Supervisory Guidance,” which can be found at 12 CFR part 262, appendix A, states that examiners will not criticize (through the issuance of matters requiring attention), a supervised financial institution for, and the Board will not issue an enforcement action on the basis of, a “violation” of or “non-compliance” with supervisory guidance.

4. See 12 CFR part 225 and 12 CFR part 238.

1045.0.6.2 *Inspection Reports for CBO Holding Companies that Receive the Full RFI/C(D) Ratings*

Section 1050.2.6 describes the inspection report content for certain holding companies in the regional banking organization (RBO) supervisory portfolio. The inspection report content in that section also generally applies to the completion of inspection reports for holding companies in the CBO portfolio that receive the full RFI/C(D) ratings. Examiners should follow the guidance in section 1050.2.6 when documenting the conclusions reached in assigning the holding company rating components and subcomponents at full-scope inspections of BHCs and SLHCs in the CBO portfolio with the following characteristics:

- The holding company has total consolidated assets greater than or equal to \$3 billion and less than \$10 billion, regardless of complexity or the entity type of the lead IDI subsidiary; and
- The holding company has a composite rating of “1,” “2,” or “3.”

In addition, examiners should follow the guidance in section 1050.2.6 for completing inspection reports for any complex holding company with less than \$3 billion in total consolidated assets that has a composite rating of “1,” “2,” or “3.”

1045.0.6.3 *Inspection Reports for Complex CBO Holding Companies Rated “4” or “5”*

Section 1001.1, “Community Bank Supervision Process,” of the *Commercial Bank Examination Manual* describes the use of a letter-format examination report in lieu of the standard, longer-form report for communicating the findings of safety-and-soundness examinations and inspections of community banking organizations that result in composite supervisory ratings of “4” or “5.” The purpose of using the letter format for these poorly rated institutions is to enable Reserve Bank examination staff to focus their reports on key findings and improve the communication of supervisory expectations to companies in need of significant improvement. Furthermore, these institutions are examined with increased fre-

quency, and the letter format hastens the communication of supervisory expectations to the institution.<sup>7</sup>

Examiners have the option to use a letter-format report for inspections in support of complex BHC and SLHC inspections that result in a rating of “4” or “5.” The content of these reports should be tailored to each company and fully support the ratings that are assigned. The letter-format inspection report for complex holding companies rated “4” or “5” should cover the following areas:

- scope of the inspection
- matters requiring attention
- analysis of consolidated, parent company, non-bank and bank subsidiary financial factors
- conclusions regarding the internal and external audit program

In addition, any applicable areas that are described in the report of inspection instructions (see this manual’s section 1050.2.6) and are necessary to support examiners’ findings should be included. As with any report of inspection, the letter-format reports must notify a banking organization and its board of the organization’s supervisory rating and the confidential nature of the report. The letter-format report should also set forth the deadline by which the organization must reply to the Reserve Bank, including the organization’s plans to address any matters requiring immediate attention or matters requiring attention that are noted in the report.

1045.0.7 COMPLETION STANDARD FOR EXAMINATION AND INSPECTION REPORTS

Safety-and-soundness examination and inspection reports for CBOs issued by the Federal Reserve should be completed and sent to the supervised institution within 60 calendar days following the “close date” of the examination.<sup>8</sup> These standards apply to formal examination and inspection reports for institutions supervised by the Federal Reserve with less than \$10 billion in total consolidated assets including state member banks, BHCs, SLHCs, Edge Act and agreement corporations, U.S. branches and agencies of foreign banks, and foreign subsidi-

7. See also [SR-19-5](#), “Communication Expectations for Community Bank Examinations and Inspections.”

8. This completion standard gives recognition to the continuous monitoring and roll-up supervisory process for larger organizations having \$10 billion or more in total consolidated assets.

aries and branches of U.S. banks.<sup>9</sup> For institutions rated composite “3,” “4,” or “5,” Reserve Banks are encouraged to adopt an internal target of 45 calendar days from the close date for sending the reports.

The “close date” of an on-site examination and inspection is defined as the last date that the examination team is physically on-site at the institution. For examinations and inspections for which all or a portion of the work is performed off-site, the “close date” is defined as the earlier of the following dates: (1) the date when the analysis (including loan file review) is completed and ready for the examiner-in-charge’s review or (2) the date when the preliminary exit meeting is held with management, which can be conducted either on-site or off-site by conference call.

Further, to ensure that findings are communicated to a supervised institution in a timely manner, Reserve Banks should ensure that the duration between the start of an examination/inspection to the completion and delivery of an examination/inspection report does not exceed 90 days.<sup>10</sup> In cases when reports are subject to statutory requirements for other state or federal agency review, such as by the Consumer Financial Protection Bureau (CFPB),<sup>11</sup> Reserve Banks may exceed these guidelines at the discretion of senior management. However, deviations from these guidelines are expected to be rare. At the discretion of senior Reserve

Bank management, additional exemptions from this 90-day guideline may be considered for examinations that are conducted simultaneously on multiple affiliated banks or examinations of larger complex CBOs that require additional time on-site to review specialized or complex business lines.

Findings and conclusions delivered to a supervised institution at the close date and exit meetings for examinations and inspections must be consistently documented in workpapers.<sup>12</sup> At a minimum, documentation should include

1. a list of attendees at the meetings;
2. a description of significant examination and inspection findings discussed, including preliminary ratings; and
3. a summary of the bank management’s views on the findings and, if applicable, the views of the board of directors.

To the extent conclusions in the final report differ from those discussed at the close date and exit meetings, Reserve Bank examiners and supervisory staff should communicate the reasons for the differences to the supervised institution and document these discussions in their workpapers. See [SR-13-14](#), “Timing Standards for the Completion of Safety-and-Soundness Examination and Inspection Reports for Community Banking Organizations,” for more information.

9. Most BHCs and SLHCs with less than \$3 billion in total consolidated assets are subject to a separate program that has different requirements for the issuance of reports of inspection.

10. The start date is the date that Reserve Bank examiners and supervisory staff commence the examination and inspection work, excluding pre-examination visitations and preparation.

11. See sections 1022, 1024, and 1025 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. For more information on the coordination of supervisory activities with the CFPB, see also the “Memorandum of Understanding on Supervisory Coordination” and the June 4, 2012, [joint press release](#).

12. In some cases, Reserve Bank examiners or supervisory staff may conduct a pre-exit meeting with the institution’s management at the close date of the examination or inspection. Representatives from the on-site examination or inspection team may also hold a final exit meeting with the institution after vetting examination or inspection findings with the responsible Reserve Bank officer(s). An “exit meeting” is defined as an examiner’s meeting with the institution’s management or management and board of directors to communicate preliminary supervisory findings and conclusions.

### WHAT'S NEW IN THIS REVISED SECTION

*Effective January 2015, this section was revised to delete a reference to SR-99-15, which was superseded by SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions."*

The continuing growth in the size and complexity of many banking organizations exposes these firms to a wide array of potential risks, while at the same time making it more challenging for a single supervisor to have a complete view of firmwide risks and controls. In response to these trends, and to better fulfill both its responsibilities as consolidated supervisor and its other central bank objectives, the Federal Reserve continues to refine and enhance its programs for the consolidated supervision of bank holding companies (BHCs) and the combined U.S. operations of foreign banking organizations (FBOs).

The Federal Reserve has set forth its consolidated supervision program for bank holding companies and the combined U.S. Operations of Foreign Banking Organizations in SR-08-9/CA-08-12 and its attachments. (See sections 1050.1 for the consolidated supervision of large complex banking organizations and see 1050.2 for the consolidated supervision of regional banking organizations.) The primary objectives of this supervisory guidance are to specify principal areas of focus for consolidated supervision activities and thereby provide for consistent Federal Reserve supervisory practices and assessments across organizations with similar activities and risks. Consistent with these objectives, the SR letter and its attached guidance detail specific expectations for Federal Reserve staff for understanding and assessing primary governance functions and risk controls, material business lines, nonbank operations, financial condition, and other key activities and risks at banking organizations; address unique aspects of supervising the combined U.S. operations of FBOs; and highlight the supervisory attention that should be paid to risk-management systems and internal controls used by BHCs and FBOs that provide core clearing and settlement services (core clearing and settlement organizations) or that have a significant presence in critical or key financial markets.<sup>1</sup> The guidance also reiterates

the importance of coordination with, and reliance on, the work of other relevant primary supervisors and functional regulators.

The Federal Reserve's enhanced approach to consolidated supervision emphasizes several elements that should help make the financial system more resilient. These include focus on corporate governance, capital adequacy, funding and liquidity management, and the supervision of material nonbank subsidiaries,<sup>2</sup> as well as other aspects of the Federal Reserve's consolidated supervision activities designed to further the objectives of fostering financial stability and deterring or managing financial crises. In addition, the Federal Reserve continues to work, both independently and in conjunction with other domestic and foreign bank supervisors and functional regulators, on a number of other initiatives to strengthen supervisory approaches and reinforce expectations for sound practices in response to recent lessons learned.

### 1050.0.1 SUPERVISION AND REGULATION FRAMEWORK FOR COMPANIES THAT CONTROL A BANK AND THE SUBSIDIARIES OF SUCH COMPANIES

The Bank Holding Company Act (BHC Act), originally enacted in 1956, provides a federal framework for the supervision and regulation of all domestic and foreign companies that control a bank and the subsidiaries of such companies. Among the principal purposes of the BHC Act is to protect the safety and soundness of corporately controlled banks. Financial trouble in one part of an organization can spread rapidly to other parts of the organization; moreover, large BHCs increasingly operate and manage their businesses on an integrated basis across corporate boundaries. Risks that cross legal entities or that are managed on a consolidated basis cannot be monitored properly through supervision directed at any one of the legal entity subsidiaries within the overall organization.

The BHC Act provides for all BHCs, including financial holding companies formed under

settlement organizations," "critical financial markets," and "key financial markets."

2. The term "nonbank subsidiaries" as used in SR-08-9/CA-08-12 and its attachments does not include savings associations.

1. See Attachment C to SR-08-9/CA-08-12 or this section's appendix for the definitions of "core clearing and

the Gramm-Leach-Bliley Act (GLBA), to be supervised on a consolidated basis by the Federal Reserve. Consolidated supervision of a BHC encompasses the parent company and its subsidiaries, and allows the Federal Reserve to understand the organization's structure, activities, resources, and risks, as well as to address financial, managerial, operational, or other deficiencies before they pose a danger to the BHC's subsidiary depository institutions.

To carry out these responsibilities, the BHC Act grants the Federal Reserve broad authority to inspect and obtain reports from a BHC and its subsidiaries concerning, among other things, the company's financial condition, systems for monitoring and controlling financial and operational risks, and compliance with the BHC Act and other federal law (including consumer protection laws) that the Board has specific jurisdiction to enforce. In addition, federal law authorizes the Federal Reserve to take action against a BHC or nonbank subsidiary to prevent these entities from engaging in unsafe or unsound practices or to address violations of law that occur in connection with their own business operations even if those operations are not directly connected to the BHC's subsidiary depository institutions. Using its authority, the Federal Reserve also has established consolidated capital standards for BHCs, helping to ensure that a BHC maintains adequate capital to support its groupwide activities, does not become excessively leveraged, and is able to serve as a source of strength for its depository institution subsidiaries.

The Federal Reserve's consolidated supervision program has served as the benchmark for many of the current and evolving international standards for the consolidated supervision of financial groups. Key concepts that have been part of the Federal Reserve's approach to consolidated supervision for many years are reflected in the Basel Committee on Banking Supervision's *Minimum Standards for Internationally Active Banks* (1992), capital accords (1988 and 2006), and *Core Principles for Effective Banking Supervision* (1997 and 2006), and are now used by the International Monetary Fund and the World Bank in connection with their assessments of countries' bank supervisory regimes.

In addition to its role as consolidated supervisor of BHCs, the Federal Reserve also is responsible for the overall supervision of the U.S. operations of foreign banks that have a banking presence in the United States. This role was

established by the International Banking Act of 1978, which introduced a policy of national treatment<sup>3</sup> promoting competitive equality between FBOs operating in the United States and domestic banking organizations. The Foreign Bank Supervision Enhancement Act of 1991 established uniform federal standards for entry, expansion, and supervision of FBOs in the United States and increased the Federal Reserve's supervisory responsibility and authority over the U.S. operations of FBOs. This act also introduced the requirement that the Federal Reserve approve the establishment of all U.S. banking offices of foreign banks and, in that regard, take into account whether the foreign bank is subject to comprehensive, consolidated supervision by its home-country supervisor.

The Federal Reserve's consolidated supervision activities closely complement its other central bank responsibilities, including the objectives of fostering financial stability and deterring or managing financial crises. The information, expertise, and powers that the Federal Reserve derives from its supervisory authority enhance its ability to help prevent financial crises and to manage such crises (in consultation and conjunction with the Treasury Department and other U.S. and foreign authorities) should they occur. Similarly, the supervisory responsibilities of the Federal Reserve benefit from its responsibilities for financial stability. For example, knowledge gained about financial market developments through interactions with primary dealers in government securities and capital market expertise derived from nonsupervisory activities improve the Federal Reserve's ability to understand and evaluate the activities of banking organizations and otherwise enhance its contributions to supervisory and regulatory policy initiatives.

Effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and relevant primary supervisors and functional regulators.<sup>4</sup> These relation-

3. "National treatment" refers to a policy that generally gives foreign banks operating in the United States the same powers as U.S. banking organizations and subjects them to the same restrictions and obligations.

4. The term "primary supervisor" as used in this document refers to the primary federal banking or thrift supervisor (for example, the Office of the Comptroller of the Currency for a nationally chartered bank) of a depository institution subsidiary of a BHC, or of a U.S. banking office of an FBO. For state-chartered depository institutions or banking offices, this term also includes the relevant bank supervisory authority of the institution's chartering/licensing state. Where a BHC has multiple depository institution subsidiaries or an FBO has multiple U.S. banking offices, there may also be multiple primary banking supervisors, depending on how the subsidiaries are chartered/licensed. The term "functional regulator"

ships respect the individual statutory authorities and responsibilities of the respective supervisors and regulators and provide for appropriate information flows and coordination so that individual responsibilities can be carried out effectively, while limiting the potential for duplication or undue burden. Information sharing among domestic and foreign supervisors, consistent with applicable law and the jurisdiction of each supervisor, is essential to ensure that a banking organization's global activities are supervised on a consolidated basis.

These concepts underlie the provisions of the GLBA governing the interaction between the Federal Reserve, as consolidated supervisor, and the other primary supervisors or functional regulators that may be involved in supervising one or more subsidiaries of a BHC.<sup>5</sup> Under these provisions, the Federal Reserve, in conducting its consolidated supervisory responsibilities, relies to the fullest extent possible on (1) the reports that a BHC or subsidiary has provided to another federal or state supervisor or to an appropriate self-regulatory organization, (2) information that is otherwise required to be reported publicly, and (3) externally audited financial statements. In addition, the Federal Reserve relies to the fullest extent possible on the reports of examination of a depository institution made by its appropriate federal or state bank supervisor, of a broker-dealer or investment adviser made by or on behalf of the SEC or relevant state regulatory authority, or of a licensed insurance company made by or on behalf of its appropriate state regulatory authority. In developing its overall assessment of a BHC or the combined U.S. operations of an FBO, the Federal Reserve also relies to the fullest extent possible on the information gathered and assessments developed by these other supervisors and regulators.

Similarly, the Federal Reserve seeks to assist relevant primary supervisors and functional regulators in performing their supervisory responsibilities with respect to regulated subsidiaries by sharing pertinent information that relates to these regulated subsidiaries consistent with each agency's supervisory responsibilities and applicable law. Examples include shared information relating to the financial condition, risk-management

policies, and operations of a banking organization that may have a material impact on regulated subsidiaries, as well as information concerning transactions or relationships between regulated subsidiaries and their affiliates.

## 1050.0.2 KEY OBJECTIVES FOR, AND APPROACHES TO, CONSOLIDATED SUPERVISION

The Federal Reserve uses a systematic approach to develop an assessment of a BHC on a consolidated basis and of the combined U.S. operations of an FBO. These assessments are reflected in the RFI (Risk-Management, Financial Condition, and Impact) rating assigned to a BHC<sup>6</sup> and the combined U.S. operations rating assigned to an FBO with multiple U.S. operations.<sup>7</sup> The Federal Reserve utilizes three principal processes to understand, supervise, and assess BHCs and FBOs: continuous monitoring activities,<sup>8</sup> discovery reviews,<sup>9</sup> and testing.<sup>10</sup>

6. The RFI rating system for BHCs is discussed in SR-04-18, "Bank Holding Company Rating System" and section 4070.0. RFI ratings are assigned at least annually for BHCs with \$1 billion or more in consolidated assets, and are communicated via a comprehensive summary supervisory report that supports the BHC's assigned ratings and encompasses the results of the entire supervisory cycle.

7. SR-00-14, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations," discusses the U.S. combined operations rating for an FBO and other aspects of the FBO Supervision Program. The Federal Reserve's rating and assessment, as well as a summary of condition analysis describing the strengths and weaknesses of the FBO's combined U.S. operations, are provided to the head office of each FBO. This information is also shared with the FBO's home-country supervisor so that it may assess the impact of U.S. operations on the parent banking organization in its role as consolidated supervisor of the banking organization's global operations.

8. "Continuous monitoring activities" are nonexamination/inspection supervisory activities primarily designed to develop and maintain an understanding of the organization, its risk profile, and associated policies and practices. These activities also provide information that is used to assess inherent risks and internal control processes. Such activities include meetings with banking organization management; analysis of management information systems (MIS) and other internal and external information; review of internal and external audit findings; and other efforts to coordinate with, and utilize the work of, other relevant supervisors and functional regulators (including analysis of reports filed with, or prepared by, these supervisors or regulators, or appropriate self-regulatory organizations, as well as related surveillance results).

9. A "discovery review" is an examination/inspection activity designed to improve the understanding of a particular business activity or control process—for example, to address a knowledge gap identified during the risk assessment or other supervisory process.

as used in this document refers to the appropriate federal (examples include the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission) or state regulator for a functionally regulated nondepository subsidiary or affiliate of a BHC or FBO. (See SR-00-13, "Framework for Financial Holding Company Supervision.") For U.S. operations of FBOs, the U.S. supervisor of a U.S. banking office is referred to as a domestic primary supervisor.

5. See SR-00-13.

The Federal Reserve's supervisory objectives are the same for all BHCs and FBOs. However, the type and amount of information and the scope and extent of Federal Reserve supervisory and examination<sup>11</sup> work that are necessary to understand, supervise, and develop an assessment of an individual BHC or the U.S. operations of an individual FBO vary. Federal Reserve supervisory activities are tailored for each organization based on a variety of factors, including the organization's legal entity and regulatory structure;<sup>12</sup> the risks posed by the organization's specific activities and systems; and the potential effect of weaknesses in control functions on the organization, its subsidiary depository institutions, or key financial markets. For example, additional supervisory activities, including transaction testing in appropriate circumstances, may be conducted when there are information gaps relating to material risks or activities, indications of weaknesses in risk-management systems or internal controls, or indications of violations of consumer protection or other laws, or when a consolidated organization or subsidiary depository institution is in less-than-satisfactory condition.

### 1050.0.2.1 Key Supervisory Objectives

In fulfilling its responsibilities for supervising a BHC on a consolidated basis and the combined U.S. operations of an FBO, the Federal Reserve is guided by the following key supervisory objectives.

10. "Testing" is an examination/inspection activity to assess whether a control process is appropriately designed and achieving its objectives or to validate a management assertion about an organization's operations. Activities may include the review and validation of internal MIS, such as business records related to an internal control process; audit findings and processes; or a sample of transactions that have been entered into by a banking organization.

11. While by definition "examination" activities are applicable to the supervision of banks and other depository institutions, as well as U.S. banking offices of FBOs, and "inspection" activities are applicable to the supervision of BHCs and nonbank subsidiaries and affiliates, the term "examination" is generally used throughout this guidance to refer to both examination and inspection activities.

12. An organization's "regulatory structure" refers to the various legal entities within the organization that are subject to oversight by different domestic and foreign supervisors or functional regulators.

#### *1050.0.2.1.1 Understanding the Bank Holding Company on a Consolidated Basis and the Combined U.S. Operations of an FBO*

*Supervisory Objective:* The Federal Reserve develops a comprehensive understanding of each BHC and the combined U.S. operations of each FBO. Key elements in developing this understanding include

- corporate strategy and significant activities;
- business line, legal entity, and regulatory structure, including interrelationships and dependencies across multiple legal entities;
- corporate governance, risk management, and internal controls for managing risks; and
- for certain organizations, presence in critical or key financial market activities.

#### *1050.0.2.1.2 Assessing the Bank Holding Company on a Consolidated Basis and the Combined U.S. Operations of an FBO*

*Supervisory Objective:* The Federal Reserve supervises each BHC on a consolidated basis and assigns an RFI rating through an evaluation and assessment of the following areas

- key corporate governance, risk management, and control functions (including, where applicable, such functions as they relate to core clearing and settlement activities and activities where the organization has a significant presence in critical or key financial markets);
- the adequacy of the financial condition of the consolidated organization; and
- the potential negative impact of nonbank entities on subsidiary depository institutions.

The Federal Reserve also supervises and assesses the combined U.S. operations of each FBO and assigns a U.S. combined operations rating based on analysis of these same elements.

#### *1050.0.2.1.3 Interagency Coordination*

*Supervisory Objective:* As noted earlier, effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and relevant domestic and foreign supervisors and functional regulators. To achieve this objective, while limiting the potential for duplication or undue burden, the nature and scope of Federal Reserve work is tailored to the organization's legal entity and regulatory structure as

well as the risks associated with the organization's activities. In this regard, the Federal Reserve

- relies to the fullest extent possible on assessments and information developed by other relevant domestic and foreign supervisors and functional regulators;
- focuses supervisory attention on material risks from activities that are not supervised by another supervisor or regulator or that cut across legal entities; and
- participates in the sharing of information among domestic and foreign supervisors and functional regulators, consistent with applicable law, to provide for the comprehensive, consolidated supervision of each banking organization's global activities.

Since coordination with, and reliance on, the work of other relevant primary supervisors and functional regulators is so central to the Federal Reserve's conduct of consolidated supervision, direction for achieving these objectives is closely integrated into the attached guidance for understanding and assessing consolidated BHCs and the combined U.S. operations of FBOs.

### 1050.0.2.2 Risk-Focused Approach to Consolidated Supervision

The Federal Reserve uses a risk-focused approach to supervision of banking organizations in general and to each organization individually. In this regard, the Federal Reserve focuses supervisory activities on identifying the areas of greatest risks to a banking organization and assessing the ability of the organization's management to identify, measure, monitor, and control these risks. In addition, the Federal Reserve typically is more actively and comprehensively engaged in the supervision of the largest and most complex BHCs and FBOs, as well as those with the most dynamic risk profiles. By paying particular attention to these organizations, the Federal Reserve aims to minimize significant adverse effects on the public (including consumers), the financial markets, and the financial systems in the United States and abroad, as well as on taxpayers, who provide the ultimate resources behind the federal safety net.

The Federal Reserve also focuses special supervisory attention on the risk-management systems and internal controls used by core clearing and settlement organizations or organizations that have a significant presence in key financial markets. In light of the potential for problems in these areas to transmit an adverse

impact across the banking and financial system, these activities pose special legal, reputational, and other risks to the banking organization and its depository institution subsidiaries. The Federal Reserve has unique expertise and perspective in these areas based on its broader central bank responsibilities and functions.

Unlike banks, nonbank subsidiaries of a banking organization may not accept FDIC-insured deposits and do not have routine access to the Federal Reserve's discount window and payment system. As a result, certain laws and supervisory policies that apply to banks (e.g., the prompt-corrective-action framework<sup>13</sup>) do not apply to nonbank subsidiaries, and the manner in which the Federal Reserve supervises the nonbank subsidiaries of a banking organization reflects these differences. The Federal Reserve's supervision of nonbank subsidiaries under the BHC Act is primarily directed toward, and focused on, ensuring that the nonbank subsidiary does not present material financial, legal, or reputational risks to affiliated depository institutions or to the BHC's or FBO's ability to support these depository institutions. The Federal Reserve also may interact with nonbank entities, such as primary dealers in government securities, in connection with its other central bank functions and responsibilities, including conducting monetary policy, fostering financial stability, and deterring or managing financial crises.

As part of the supervisory process, the Federal Reserve reviews the systems and controls used by BHCs and the U.S. operations of FBOs to monitor and ensure that the organization, including its nonbank subsidiaries, complies with applicable laws and regulations, including those related to consumer protection. The Federal Reserve develops and maintains an understanding and assessment of consumer compliance risk at nonbank subsidiaries of a BHC or FBO primarily through continuous monitoring activities, relying to the fullest extent possible on work performed by the relevant functional regulator, if any. While the Federal Reserve routinely conducts examinations of the compliance function at the BHC, including its systems for monitoring and ensuring compliance with consumer and other applicable laws, the Federal Reserve currently does not routinely conduct examinations for the purpose of determining

13. For more information on the prompt-corrective-action framework for banks, see section 4133.1 of the Federal Reserve's *Commercial Bank Examination Manual*, or see 12 C.F.R. 208, Subpart D.

compliance with specific consumer laws enforced primarily by other supervisors regarding non-bank subsidiaries of BHCs and FBOs. When consumer compliance-related deficiencies are noted as part of the ongoing supervision of a BHC or FBO, however, consumer compliance examiners may conduct onsite examinations (including transaction testing, if appropriate) of nonbank subsidiaries to resolve significant issues that have the potential for widespread violations or harm to consumers.<sup>14</sup>

The Federal Reserve also seeks to reinforce market discipline by encouraging public disclosures that balance quantitative and qualitative information with clear discussions about risk-management processes and that reflect evolving disclosure practices for peer organizations.

### 1050.0.2.3 Supervisory Portfolios

An important aspect of the Federal Reserve's consolidated supervision programs for BHCs and the combined U.S. operations of FBOs is the assessment and evaluation of practices across groups of organizations with similar characteristics and risk profiles. This "portfolio approach" to consolidated supervision facilitates greater consistency of supervisory practices and assessments across comparable organizations and enhances the Federal Reserve's ability to identify outlier organizations among established peer groups. The supervisory portfolios that the Federal Reserve currently uses in structuring its supervisory programs for BHCs and the U.S. operations of FBOs are as follows:

#### *BHC Portfolios:*

- large complex banking organizations (LCBO BHCs)
- regional bank holding companies (regional BHCs)
- community bank holding companies (community BHCs)

#### *FBO Portfolios:*

- large complex foreign banking organizations (LCBO FBOs)

- multi-office foreign banking organizations (multi-office FBOs)
- single-office foreign banking organizations (single-office FBOs)

LCBOs are characterized by the scope and complexity of their domestic and international operations; their participation in large volume payment and settlement systems; the extent of their custody operations and fiduciary activities; and the complexity of their regulatory structures, both domestically and in foreign jurisdictions. To be designated as an LCBO, a banking organization must meet specified criteria to be considered a significant participant in at least one key financial market.

Banking organizations that are not designated as LCBOs belong to the portfolios of regional or community BHCs, or multi-office or single-office FBOs. While there is considerable variety among organizations across these portfolios, the simpler regulatory structure of most non-LCBO organizations increases the likelihood that a single primary supervisor has a substantially complete view of, and ability to address, significant areas of firmwide (or combined U.S. operations for FBOs) activities, risks, risk management, and controls.

## 1050.0.3 SUPERVISORY GUIDANCE

The guidance attached to SR-08-9/CA-08-12 (e.g., sections 1050.1 and 1050.2) describes how Federal Reserve staff will develop an understanding and assessment of a BHC or the U.S. operations of an FBO through continuous monitoring activities, discovery reviews, and testing activities, as well as through interaction with, and reliance to the fullest extent possible on, other relevant primary supervisors and functional regulators. Because the Federal Reserve's supervisory activities are tailored in the manner described above, separate guidance documents are provided for four different supervisory portfolios to promote appropriate and consistent supervision of organizations that broadly share similar characteristics and risk profiles. The documents' guidance addresses

- consolidated supervision of LCBO BHCs (Attachment A.1) (See section 1050.1);
- consolidated supervision of regional BHCs (Attachment A.2) (See section 1050.2);
- supervision of the combined U.S. operations of LCBO FBOs (Attachment B.1); and
- supervision of the combined U.S. operations of multi-office FBOs (Attachment B.2).

14. See SR-03-22/CA-03-15, "Framework for Assessing Consumer Compliance Risk at Bank Holding Companies," and section 2124.01.6.1.2.

As a supplement to these four guidance documents, definitions of key terms for consolidated supervision are provided in Attachment C to SR-08-9/CA-08-12 (See appendix, section 1050.0.4).

Consolidated supervision of community BHCs follows the procedures contained in SR-02-1 and section 5000.0.4.3, “Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of \$5 Billion or Less,” while supervision of single-office FBOs follows the procedures contained in SR-00-14.

### 1050.0.3.1 Overview of Significant Federal Reserve Supervisory Activities

The Federal Reserve will maintain for each BHC and the combined U.S. operations of each FBO

- an understanding of key elements of the banking organization’s strategy, primary revenue sources, risk drivers, business lines, legal entity structure, governance and internal control framework, and presence in key financial markets; and
- an assessment of (1) the effectiveness of risk-management systems and controls over the primary risks inherent in the organization’s activities, (2) the organization’s financial condition, and (3) the potential negative impact of nonbank operations on affiliated depository institutions.

This understanding and assessment will encompass both prudential and consumer compliance supervision and reflect judgments developed by Federal Reserve staff drawing from all available sources, including the work of other relevant primary supervisors and functional regulators and the organization’s internal control functions. Primary areas of focus will include

1. key corporate governance functions, including internal audit;
2. risk management and internal control functions for primary risks of the consolidated organization (or combined U.S. operations for FBOs), and supporting MIS;
3. where applicable, core clearing and settlement activities and related risk management and internal controls of firms that are large-value payment system operators and market utilities;

4. for LCBOs, activities in critical or key financial markets in which the organization plays a significant role, as well as related risk management and internal controls;
5. where applicable, areas of emerging interest with potential financial market consequences;
6. consolidated financial strength (in the case of FBOs, the financial strength of combined U.S. operations);
7. risk management and financial condition of significant nonbank subsidiaries; and
8. parent company and nonbank funding and liquidity (in the case of FBOs, funding and liquidity of U.S. operations).

By their nature, understanding and assessing some areas—such as the risk management and financial condition of significant nonbank subsidiaries that are not functionally regulated—will typically require more independent Federal Reserve supervisory work. Other areas—such as primary firmwide risk management and control functions—typically will require a greater degree of coordination with other relevant primary supervisors or functional regulators, who will likely have information or assessments upon which the Federal Reserve can draw.

The guidance in the attachments to SR-08-9/CA-08-12 outlines when the Federal Reserve will conduct (i.e., participate in or lead) testing activities in order to determine whether a control process is appropriately designed and achieving its objectives or to otherwise validate management assertions. Testing activities are an important element of the Federal Reserve’s consolidated supervision program for BHCs and the combined U.S. operations of FBOs. They supplement ongoing continuous monitoring activities and periodic discovery reviews necessary to maintain an understanding and assessment for each of these key functions.

The guidance in the SR letter’s attachments also discusses in greater detail control processes for several areas subject to testing on at least a three-year cycle, supplemented by a reassessment on at least an annual basis to identify whether changes in inherent risk or control structures, or potential concerns regarding controls, merit interim targeted testing activities. These areas are

- internal audit infrastructure;

- parent company and nonbank funding and liquidity (in the case of FBOs, funding and liquidity of U.S. operations);
- where applicable, core clearance and settlement activities; and,
- where applicable, activities in critical financial markets in which the organization plays a significant role.<sup>15</sup>

There may also be instances when additional supervisory activities are necessary to improve the understanding and/or to assess the adequacy of key corporate governance functions or risk management or internal control functions for primary risks due to significant changes, potential concerns, or the absence of recent testing.

All cycle times set forth in the guidance for testing represent maximum periods between testing activities. Shorter cycle times should be utilized whenever significant changes occur in, or material concern exists regarding, a key governance, risk-management, or internal control function.

In conducting the activities described in the guidance, the Federal Reserve will rely to the fullest extent possible on the information and assessments of relevant primary supervisors and functional regulators, and will work with such supervisors and regulators to align each agency’s assessment of key corporate governance functions, risk-management and internal control functions for primary risks, financial condition, and other areas of consolidated BHC or combined U.S. FBO operations, as applicable. In addition, because of the specific statutory limitations that apply with respect to functionally regulated subsidiaries of a BHC or FBO, the Federal Reserve will continue to adhere to the procedures and limits described in SR-00-13 (see sections 3900.0 and 1040.0) in conducting any examination of, or requesting a specialized report from, a functionally regulated subsidiary of a BHC or FBO.<sup>16</sup> Under these provisions, for

example, the Federal Reserve may conduct an examination of a functionally regulated subsidiary if, after reviewing relevant reports, it reasonably determines that the examination is necessary to adequately inform the Federal Reserve about the systems used to monitor and control financial and operational risks within the consolidated organization that may pose a direct or indirect threat to the safety and soundness of a depository institution subsidiary.

1050.0.3.2 Application of Supervisory Guidance

As a general matter, the supervisory expectations and processes of the guidance documents that are attached to SR-08-9/CA-08-12 are intended for use in supervising BHCs and the combined U.S. operations of FBOs in circumstances where both the banking organization and its subsidiary depository institutions are in at least satisfactory condition and there are no indications of material weakness in the organization’s risk management or internal controls. Additional Federal Reserve supervisory activities may be necessary or appropriate if the banking organization is facing, or is expected to face, material financial, managerial, operational, legal, or reputational difficulties, or is the subject of an investigation or formal or informal enforcement action.

Section IV of each of the documents attached to SR-08-9/CA-08-12 (see sections 1050.1.4 and section 1050.2.4) provides additional guidance on the steps the Federal Reserve will take to coordinate with other supervisors in certain special situations. This guidance does not limit any authority that the Federal Reserve may have under applicable law and regulations, including the authority to obtain reports or conduct examinations or inspections. Moreover, because this guidance relates to supervisory practices, it does not address or limit the circumstances under which the Federal Reserve may take formal or informal enforcement action against a banking organization or other person.

This supervisory guidance is not intended to comprehensively describe all elements of an effective supervision program for BHCs or U.S. operations of FBOs. Rather, the guidance supplements, and should be used in conjunction with, existing Federal Reserve guidance, including among others the *Bank Holding Company Supervision Manual*; the *Examination Manual for*

15. For these activities, the three-year testing cycle focuses on adherence with expectations of the *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System* (see SR-03-9), including the geographic diversity and resiliency of data centers and operations, and testing of recovery and resumption arrangements.

16. For these purposes, a “specialized report” means a report that the functionally regulated subsidiary is not required to prepare for another federal or state regulatory authority or an appropriate self-regulatory organization. Consistent with the GLBA, if the Federal Reserve seeks to obtain a specialized report from a functionally regulated subsidiary, the Federal Reserve will first request that the subsidiary’s appropriate

regulatory authority or self-regulatory organization obtain the report and make it available to the Federal Reserve.

*U.S. Branches and Agencies of Foreign Banking Organizations*; SR-04-18; SR-03-22/CA-03-15; SR-00-14; and SR-00-13.

## 1050.0.4 APPENDIX—DEFINITIONS OF KEY TERMS FOR CONSOLIDATED SUPERVISION

### 1050.0.4.1 Supervisory Objectives

*Assessing*: To go beyond developing an *understanding* by making supervisory judgments regarding the degree of inherent risks or evaluating whether risk-management and internal control practices are functioning as intended, and whether they are adequate relative to the risk taken. It is often necessary for bank supervisors or *functional regulators* to conduct *testing* activities as a means to arrive at an assessment.

*Understanding*: To gain comprehensive insight into the nature of a business activity, its related risks, and the design of risk-management and compensating controls. Understanding also involves comprehending the significance of such activities, risks, and controls for the institution's safety and soundness. *Continuous monitoring* or *discovery reviews* are often utilized to develop an understanding of a banking organization's operations and the related inherent risk and controls.

### 1050.0.4.2 Supervisory Activities

*Active participation*: When the Federal Reserve has input into determining the objectives, final conclusions, and related communications to institution management for an *examination* led by another *relevant primary supervisor* or *functional regulator*.

*Continuous monitoring*: Non-examination/inspection supervisory activities primarily designed to develop and maintain an *understanding* of the organization, its risk profile, and associated policies and practices. These activities also provide information that is used to *assess* inherent risks and internal control processes. Such activities include meetings with banking organization management; analysis of management information systems (MIS) and other internal and external information; review of internal and external audit findings; and other efforts to coordinate with, and utilize the work of, other relevant supervisors and *functional regulators*, including analysis of reports filed

with, or prepared by, these supervisors or regulators, or appropriate self-regulatory organizations, as well as related surveillance results.

*Discovery review*: An *examination/inspection* supervisory activity designed to improve the *understanding* of a particular business activity or control process—for example, to address a knowledge gap identified during the risk assessment or other supervisory process. If questions regarding the adequacy of practices or sufficiency of information are raised during this review, it will likely be necessary to conduct further and more in-depth *examination* activity (e.g., *testing*).

*Examination/inspection*: Examination activities are applicable to the supervision of banks and other depository institutions, as well as *U.S. banking offices* of FBOs, and inspection activities are applicable to the supervision of BHCs and nonbank subsidiaries and affiliates. Examination and inspection activities are generally described as examinations throughout this guidance.

*Testing*: An *examination/inspection* supervisory activity designed to go beyond a *discovery review*, as it will result in an *assessment* of whether a control process is appropriately designed and achieving its objectives, or validation of a management assertion about an organization's operations. Such activities may include the review and validation of internal MIS, such as business records related to an internal control process; audit findings and processes; or a sample of transactions that have been entered into by a banking organization.

### 1050.0.4.3 Foreign Banking Organization Supervision

*Booked in*: Recorded on the books and records of the legal entity in question. For supervisory purposes, the U.S. operations of FBOs include activities that are booked in or *traded through* U.S. operations.

*Comprehensive, consolidated supervision*: An FBO is supervised or regulated in such a manner that its home-country supervisor receives sufficient information on the worldwide operations of the FBO (including the relationship of

the bank to any affiliate) to assess the FBO's overall financial condition and compliance with law and regulation. The Foreign Bank Supervision Enhancement Act of 1991 introduced the requirement that the Federal Reserve approve the establishment of all *U.S. banking offices* of FBOs, and in that connection, take into account whether the FBO is subject to comprehensive, consolidated supervision by its home-country supervisor.

*Multi-office foreign banking organizations:* All FBOs except for (1) those that are designated as being part of the portfolio of LCBOs and (2) FBOs whose U.S. operations consist solely of a single *U.S. banking office*.

*National treatment:* As established by the International Banking Act of 1978 (IBA), a policy that requires nondiscrimination between domestic and foreign firms or treatment of foreign entities that is no less favorable than that accorded to domestic enterprises in like circumstances. This policy generally gives foreign banks operating in the United States the same powers as U.S. banking organizations and subjects them to the same restrictions and obligations.

*Net due to / from positions:* Net due to and from positions refer to the flow of funds between a U.S. branch or agency and its parent FBO (including other affiliated depository institutions). For example, a U.S. branch is in a net due from position with its parent FBO if the parent owes funds to the branch once all transactions between the branch and the parent are netted.

*Qualifying foreign banking organizations (QFBOs):* FBOs that are entitled to certain exemptions from the nonbanking activities restrictions of the Bank Holding Company Act, including for certain limited commercial and industrial activities in the United States. The Federal Reserve does not *examine* or supervise these commercial/industrial activities. The Federal Reserve monitors the extensions of credit by *U.S. banking offices* of foreign banks to U.S. companies held directly under this authority to ensure that such loans are made on market terms.

*Traded through:* Transacted or arranged by the personnel of the institution in question (in an agent role), but booked at a different related

legal entity. For supervisory purposes, the U.S. operations of FBOs include activities that are *booked in* or traded through U.S. operations.

*U.S. banking offices:* U.S. depository institution subsidiaries of FBOs and branches/agencies of FBOs.

*U.S. nonbank affiliates of U.S. banking offices:* U.S. BHC parent companies and their nonbank subsidiaries, as well as other U.S. nonbank affiliates and representative offices held directly by the FBO.

#### 1050.0.4.4 Other Terms

*Banking Organization National Desktop (BOND):* A Federal Reserve information technology platform providing secure interagency access to documents, supervisory and financial data, and other information utilized in the *consolidated supervision* of individual BHCs and FBOs, and in developing comparative analyses of institutions with similar business lines and risk characteristics.

*College of supervisors:* A multilateral group of supervisors that discusses issues related to specific internationally active banking organizations. The Federal Reserve participates in colleges of supervisors as both a home-country supervisor of internationally active U.S. BHCs and as a host-country supervisor of the U.S. operations of FBOs.

*Consolidated supervision (also known as “umbrella” or “groupwide” supervision):* Supervision of a BHC on a groupwide basis, including its nonbanking subsidiaries, providing important protection to its subsidiary banks and to the federal safety net beyond that afforded by supervision of a bank individually. Consolidated supervision allows the Federal Reserve to *understand* the financial and managerial strength and risks within the consolidated organization as a whole, providing the ability to address significant management, operational, capital, or other deficiencies within the overall organization before they pose a threat to subsidiary banks.

*Core clearing and settlement organizations:* As defined in the “Interagency Paper on Sound Practices to Strengthen the Resilience of the U. S. Financial System” (SR-03-9), two groups of organizations that provide clearing and settlement services for *critical financial markets* or

act as large-value payment system operators, and present the potential for *systemic risk* should they be unable to perform. The first group consists of market utilities (government-sponsored services or industry-owned organizations), whose primary purpose is to clear and settle transactions for *critical markets* or transfer large-value wholesale payments. The second group consists of those private-sector firms that provide clearing and settlement services that are integral to a *critical market* (i.e., their aggregate market share is significant enough to present the potential for *systemic risk* in the event of their sudden failure to carry out those activities because there are no viable immediate substitutes).

*Critical financial markets:* As defined in the “Interagency Paper on Sound Practices to Strengthen the Resilience of the U. S. Financial System,” the markets for federal funds, foreign exchange, and commercial paper; U.S. government and agency securities; and corporate debt and equity securities.

*Domestic BHC:* A BHC incorporated in the United States that is not controlled by an FBO.

*Double leverage:* Situations in which debt is issued by the parent company and the proceeds are invested in subsidiaries as equity.

*Financial instability:* When external events or market behavior in the financial system are substantial enough to significantly distort or impair national or global financial markets or to create significant risks for real aggregate economic performance. Banking organizations with a considerable presence in activities that are potentially vulnerable to such externalities—or that are capable of contributing to financial instability if not adequately managed—require supervisors to develop an *understanding* of these activities and their risk profile.

*Functional regulator:* With respect to domestic authorities, the appropriate federal (examples include the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission) or state regulator for a functionally regulated nondepository subsidiary or affiliate of a BHC or FBO.

*Key corporate governance functions:* Primary firmwide governance mechanisms relied upon by the board of directors and senior management. This includes the board and its committees, senior management and its executive committees, internal audit, and other functions (e.g.,

corporate finance and treasury functions), whose effectiveness is essential to sustaining the consolidated organization as well as a firm’s business resiliency and crisis management capabilities.

*Key financial markets:* Includes *critical financial markets* as well as (1) broader U.S. capital market activity, including underwriting, securitization, derivatives, and trading; (2) retail financial services; and (3) international financial markets.

*Key models and processes:* Those where evaluation of the model/process will influence the Federal Reserve’s *assessment* of the activity or control area that is supported by the model/process.

*Large complex banking organizations (LCBOs):* LCBOs are characterized by the scope and complexity of their domestic and international operations; their participation in large volume payment and settlement systems; the extent of their custody operations and fiduciary activities; and the complexity of their *regulatory structure*, both domestically and in foreign jurisdictions. To be designated as an LCBO, a banking organization must meet specified criteria to be considered a significant participant in at least one *key financial market*.

*Material portfolios or business lines:* Portfolio risk areas (such as retail or wholesale credit risk) or individual business lines (such as mortgage lending or leveraged lending) that are primary drivers of risk or revenue for the BHC, or that otherwise materially contribute to *understanding* inherent risk or *assessing* related controls for a broader corporate function (such as consolidated credit-risk management). When identifying these areas during the development of the institutional overview and risk assessment, as well as during other supervisory processes, consideration is given to all associated risk elements, including legal and compliance risks.

*Net debit cap:* The maximum dollar amount of uncollateralized daylight overdrafts that an institution may incur in its Federal Reserve account.

*Nonmaterial business lines:* Business lines that are not primary drivers of risk or revenue for the BHC, and are not principal contributing factors to either *understanding* risk inherent in a

broader corporate function or to *assessing* related controls.

*Nontraditional BHCs:* BHCs in which most or all of the organization's significant nondepository subsidiaries are regulated by a *functional regulator*, and subsidiary depository institution(s) are small in relation to nondepository subsidiaries.

*Other relevant primary supervisors:* Primary bank or thrift supervisors of BHC subsidiaries, including host-country supervisors (or home-country supervisors for FBOs), whose understanding and assessments are key to effective firmwide consolidated supervision.

*Primary firmwide risk management and control functions:* Mechanisms relied upon by the board of directors and senior management for identifying, measuring, monitoring, and controlling primary risks to the consolidated organization. This includes risk management and control functions for primary credit, legal and compliance, liquidity, market, operational, and reputational risks for the consolidated organization.

*Primary supervisor:* The primary federal banking or thrift supervisor (for example, the Office of the Comptroller of the Currency for a nationally chartered bank) of a depository institution subsidiary of a BHC, or of a *U.S. banking office* of an FBO. For state-chartered depository institutions or banking offices, this term also includes the relevant bank supervisory authority of the institution's chartering/licensing state. Where a BHC has multiple depository institution subsidiaries, or an FBO has multiple *U.S. banking offices*, there may also be multiple primary banking supervisors, depending on how the subsidiaries are chartered/licensed. For U.S. opera-

tions of FBOs, the U.S. supervisor of a *U.S. banking office* is referred to as a domestic primary supervisor.

*Regional bank holding companies:* BHCs with \$10 billion or more in consolidated assets (including *nontraditional BHCs*) that are not designated as *LCBOs*.

*Regulatory structure:* The various legal entities within the organization that are subject to oversight by different domestic and foreign *primary supervisors* or *functional regulators*.

*Significant nonbank activities and risks:* Where the parent company or nonbank subsidiaries engage in risk-taking activities or hold exposures that are material to the risk management or financial condition of the consolidated organization or a depository institution affiliate.

*Specialized report from a functionally regulated subsidiary:* As discussed in the GLBA, a report that the functionally regulated subsidiary is not required to prepare by another federal or state regulatory authority or an appropriate self-regulatory organization.

*Systemic risk:* The risk that the failure of one participant to meet its required obligations in a transfer system or financial market will cause other participants to be unable to meet their obligations when due, causing significant liquidity or credit problems or threatening the stability of national or global financial markets.

## WHAT'S NEW IN THIS REVISED SECTION

*Effective January 2015, this section is revised for the adoption of a new consolidated supervision framework for large banking organizations. Refer to SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions." SR-99-15 was superseded by SR-12-17/CA-12-14.*

### 1050.1.1 ACTIVITIES OF THE FEDERAL RESERVE AND OTHER SUPERVISORS AND REGULATORS, AND FUNCTIONAL REGULATION

In 1999, the Federal Reserve established its supervisory program for large complex banking organizations (LCBOs).<sup>1</sup> LCBOs are characterized by the scope and complexity of their domestic and international operations; their participation in large volume payment and settlement systems; the extent of their custody operations and fiduciary activities; and the complexity of their regulatory structure, both domestically and in foreign jurisdictions. To be designated as an LCBO, a banking organization must meet specified criteria to be considered a significant participant in at least one key financial market.<sup>2</sup>

As outlined in the following sections, a range of continuous monitoring activities is utilized, along with discovery reviews and testing activities (examination/inspection activities),<sup>3</sup> to develop and maintain an understanding and assessment of each domestic bank holding company (BHC) that is an LCBO.<sup>4</sup> These organizations are collectively referred to as large complex BHCs.

1. With the implementation of the "Consolidated Supervision Framework for Large Financial Institutions" (refer to SR-12-17/CA-12-14), SR-99-15, "Risk-Focused Supervision of Large Complex Banking Organizations," was superseded. (Refer to section 2124.05 of this manual).

2. See section 1050.0.4, Appendix, for the definitions of terms commonly used in this section and sections 1050.1 and 1050.2.

3. The term "examination" is generally used throughout this guidance to refer to both commercial bank examination and BHC inspection activities.

4. The term "domestic BHC" refers to a BHC incorporated in the United States that is not controlled by a foreign banking organization (FBO). Attachment B.1. to SR-08-9/CA-08-12 addresses—in the context of supervising the combined U.S. operations of FBOs—how the Federal Reserve will develop and maintain an understanding and assessment of a BHC that is, or is controlled by, an FBO that is itself an LCBO.

#### 1050.1.1.1 Federal Reserve Activities and Those Activities of Other Supervisors and Regulators

The nature and scope of independent Federal Reserve supervisory work required to develop and maintain an understanding and assessment of a large complex BHC depends largely on the extent to which other relevant primary supervisors or functional regulators have information or assessments upon which the Federal Reserve can draw. By their nature, understanding and assessing some areas—such as the risk management and financial condition of significant non-bank subsidiaries that are not functionally regulated—typically will require more independent Federal Reserve supervisory work. Other areas—such as primary firmwide risk-management and control functions—typically will require a greater degree of coordination with other relevant primary supervisors or functional regulators, who will likely have information or assessments upon which the Federal Reserve can draw.

The following sections provide further detail on how the Federal Reserve will develop, working in coordination with other relevant primary supervisors and functional regulators, an understanding and assessment of a large complex BHC. In conducting the activities described throughout this document, the Federal Reserve will, to the fullest extent possible

- rely on the information and assessments of relevant primary supervisors and functional regulators, including the information and assessments reflected in the reports of examination of such supervisors and regulators;
- focus its supervisory activities on the bank holding company, as well as on those of its nonbank subsidiaries that could have a direct or indirect materially adverse effect on the safety and soundness of a depository institution subsidiary of the BHC due to the size, condition, or activities of the nonbank subsidiary, or the nature or size of its transactions with the depository institution; and
- use publicly reported information (including externally audited financial statements), as well as reports that a large complex BHC or a subsidiary prepares for other primary supervisors, functional regulators, or self-regulatory organizations.

### 1050.1.1.2—Functionally Regulated Subsidiaries

As discussed below, in certain situations, the Federal Reserve may find it necessary to conduct an examination of a functionally regulated nonbank subsidiary in order to fulfill the Federal Reserve's responsibilities as supervisor of the consolidated organization. In any such case, the Federal Reserve will continue to adhere to the procedural and other requirements governing examinations of, or requests for a specialized report from, a functionally regulated subsidiary as discussed in SR-00-13 and sections 1040.0 and 3900.0. Under these provisions, for example, the Federal Reserve may conduct an examination of a functionally regulated subsidiary if, after reviewing relevant reports, it reasonably determines that the examination is necessary to adequately inform the Federal Reserve about the systems used to monitor and control financial and operational risks within the consolidated organization that may pose a direct or indirect threat to the safety and soundness of a depository institution subsidiary.<sup>5</sup>

## 1050.1.2 UNDERSTANDING THE ORGANIZATION

For each large complex BHC, the Federal Reserve will develop an understanding of the legal, operating, and corporate governance structure of the

5. The Federal Reserve also may examine a functionally regulated subsidiary of a large complex BHC if, after reviewing relevant reports and other information, it has reasonable cause to believe that the subsidiary is engaged in an activity that poses a material risk to an affiliated depository institution, or that the subsidiary is not in compliance with any federal law that the Federal Reserve Board has specific jurisdiction to enforce against the subsidiary (and the Federal Reserve cannot determine compliance by examining the BHC or its affiliated depository institutions).

Similarly, before requiring a specialized report from a functionally regulated subsidiary, the Federal Reserve first will request that the subsidiary's appropriate functional regulator obtain the report and make it available to the Federal Reserve. In the event that the report is not obtained or made available as requested, the Federal Reserve may, consistent with the Bank Holding Company Act, obtain the report directly from the functionally regulated subsidiary if the report is necessary to allow the Federal Reserve to adequately assess (1) a material risk to the BHC or any of its depository institution subsidiaries, (2) the systems used to monitor and control financial and operational risks within the consolidated organization that may pose a threat to the safety and soundness of a depository institution subsidiary, or (3) compliance with any federal law that the Federal Reserve Board has specific jurisdiction to enforce against the BHC or a subsidiary.

organization and its primary strategies, business lines, and risk-management and internal control functions.<sup>6</sup> This understanding will inform the development of a risk assessment and supervisory plan for the BHC. Typically, the information necessary to gain this understanding may be obtained from the organization's management, public reports, regulatory reports, surveillance screens, third-party sources (e.g., credit rating agency and market analyst reports), and other relevant primary supervisors or functional regulators. Key elements that should be identified and understood include the following:

- *Corporate strategy.* Primary business strategies; institutional risk tolerance; key changes in strategic direction or risk profile; significant new business activities, areas of growth and emerging areas with potential to become primary drivers of risk or revenue; and plans for expansion through mergers or acquisitions.
- *Significant activities.* Key revenue and risk drivers; primary business lines; product mix; budget and internal capital allocations; market share for revenue and customers served; key external trends, including competitive pressures; and areas that are vulnerable to volatility in revenue, earnings, capital, or liquidity.
- *Structure.* Business line and legal entity structure; domestic and foreign regulatory responsibilities for legal entities and business lines; key interrelationships and dependencies between depository institution subsidiaries and nonbank affiliates; material business lines operated across multiple legal entities for accounting or risk-management purposes; and the activities and risk profiles of Edge and agreement corporation subsidiaries.
- *Corporate governance, risk management, and internal controls for primary risks.* Board of directors (board) and executive-level committees; senior management and management committees; key risk-management and internal control functions, and associated management information systems (MIS), relied upon by the board, senior management, and senior risk managers and committees; and consistency of public disclosures with how the board and senior management assess and manage risks.

6. This understanding is formally documented during development of the institutional overview, which coincides with creation of the annual risk assessment. SR-97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions" (see section 2124.01), describes processes for developing an institutional overview, risk assessment, and supervisory plan. Each of these products is kept current to reflect significant changes in an organization's risks or activities.

- *Presence in critical or key financial markets.*<sup>7</sup> Core clearing and settlement activities; business lines with a significant presence in critical or key national or global financial markets; and related risk-management and disclosure practices.

To ensure the quality and consistency of consolidated supervision across the large complex BHC portfolio, it also is necessary to understand how these key elements compare with industry trends and with evolving practices of well-managed organizations with similar characteristics.

### 1050.1.3 ASSESSING THE LARGE COMPLEX BHC ON A CONSOLIDATED BASIS

The Federal Reserve uses a systematic approach to develop an assessment of a BHC on a consolidated basis. This assessment is reflected in the RFI (Risk Management, Financial Condition, and Impact) rating assigned to a BHC.<sup>8</sup>

#### 1050.1.3.1 Risk Management

##### *1050.1.3.1.1 Key Corporate Governance Functions*

*Objectives:* One of the primary areas of focus for consolidated supervision of large complex BHCs is the adequacy of governance provided by the board and senior management. The culture, expectations, and incentives established by the highest levels of corporate leadership set the tone for the entire organization and are essential determinants of whether a banking organization is capable of maintaining fully effective risk-management and internal control processes.

The board and its committees should have an ongoing understanding of key inherent risks, associated trends, primary control functions, and senior management capabilities. Primary expectations for the board and its committees include

1. selecting competent senior managers, ensuring that they have the proper incentives to

operate the organization in a safe and sound manner, and regularly evaluating senior managers' performance;

2. establishing, communicating, and monitoring (for example, by reviewing comprehensive MIS reports produced by senior management) institutional risk tolerances and a corporate culture that emphasizes the importance of compliance with the law and ethical business practices;
3. approving significant strategies and policies;
4. demonstrating leadership, expertise, and effectiveness;
5. ensuring the organization has an effective and independent internal audit function;
6. ensuring the organization has appropriate policies governing the segregation of duties and avoiding conflicts of interest; and
7. ensuring that public disclosures
  - are consistent with how the board and senior management assess and manage the risks of the organization,
  - balance quantitative and qualitative information with clear discussions about risk-management processes, and
  - reflect evolving disclosure practices for peer organizations.

A large complex BHC's senior management and its committees should be able to clearly communicate risk tolerances and measures, control risks, hire and retain competent staff, and respond to changes in the organization's risk profile and the external environment. Members of senior management are expected to have qualifications and experience commensurate with the size and complexity of the organization. Primary expectations for senior management include

1. establishing effective oversight and an appropriate risk culture;
2. appropriately delegating authority and overseeing the establishment and implementation of effective policies for the proper segregation of duties and for the avoidance or management of conflicts of interest;
3. establishing and implementing an effective risk-management framework capable of identifying and controlling both current and emerging risks, and effective independent control functions that ensure risk taking is consistent with the organization's established risk appetite;

7. See sections 1050.1.3.1.6 and 1050.1.3.1.7 for definitions of "critical financial markets" and "key financial markets."

8. The RFI rating system for BHCs is discussed in SR-04-18, "Bank Holding Company Rating System" (see section 4070.0). RFI ratings are assigned for BHCs that are complex or that have \$1 billion or more in consolidated assets, and are communicated via a comprehensive summary supervisory report that supports the BHC's assigned ratings and encompasses the results of the entire supervisory cycle.

4. establishing and implementing incentives for personnel that are consistent with institutional risk tolerances, compliance with the law, and ethical business practices;
5. promoting a continuous dialogue between and across business areas and risk-management functions to help align the organization's established risk appetite and risk controls;
6. ensuring that the board and its committees are provided with timely, accurate, and comprehensive MIS reports that are adaptive to changing circumstances regarding risks and controls; and
7. ensuring timely resolution of audit, compliance, and regulatory issues.

An effective internal audit function plays an essential role by providing an independent and objective evaluation of all key governance, risk-management, and internal control processes. As the complexity of financial products and supporting technology has grown, in combination with greater reliance on third-party service providers, the importance of internal audit's role in identifying risks and testing internal controls has increased.

In addition, the extent to which supervisors can rely on or utilize the work of internal audit is an essential determinant of the risk-focused supervisory program that is tailored to the activities and risks of each large complex BHC.

*Supervisory Activities:* For each large complex BHC, the Federal Reserve will understand and assess the adequacy of oversight provided by the board and senior management, as well as the adequacy of internal audit and associated MIS. The Federal Reserve also will understand and assess other key corporate governance functions (e.g., corporate finance and treasury functions), whose effectiveness is essential to sustaining consolidated holding company operations, as well as the organization's business resiliency and crisis management capabilities.

- *Board, senior management, and other key corporate governance functions.* Continuous monitoring activities—which draw from all available sources, including internal control functions, the work of other relevant primary supervisors and functional regulators, regulatory reports, and related surveillance results—will be used to understand and assess the effectiveness of board and senior management

resources and oversight.

The results of continuous monitoring activities, as documented in the institutional overview, risk assessment, and other supervisory products, may identify certain corporate governance functions that will require more intensive supervisory focus due to (1) significant changes in corporate strategy, activities, organizational structure, oversight mechanisms, or key personnel; (2) potential concerns regarding the adequacy of a specific governance function; or (3) the absence of sufficiently recent examination activities for a key function by the Federal Reserve or another primary supervisor or functional regulator.

- *Internal audit.* Continuous monitoring and examination activities will be used to understand and assess key elements of internal audit governance for the organization on a consolidated basis, including (1) the adequacy and independence of the audit committee; (2) the independence, professional competence, and quality of the internal audit function; (3) the quality and scope of the audit methodology, audit plan, and risk-assessment process; and (4) the adequacy of audit programs and workpaper standards. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there have been significant changes in the internal audit infrastructure or whether there are potential concerns regarding the adequacy of key elements of internal audit. In addition to this periodic audit infrastructure review, testing activities for specific control functions or business lines should include an assessment of internal audit's recent work in these areas to the extent possible as a means of validating internal audit's findings.
- *Additional supervisory activities.* If continuous monitoring activities identify a key corporate governance function or element of internal audit requiring more intensive supervisory focus due to significant changes, potential concerns, or the absence of sufficiently recent examination activities, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) in developing discovery reviews or testing activities focusing on the area of concern. In situations where another primary supervisor or functional regulator leads the examination activities, the Federal Reserve will participate as actively as appropriate in those activities.<sup>9</sup>

If the area of concern is not within the oversight of another primary supervisor or functional regulator, or if the supervisor or regulator does not conduct or coordinate the examination activities in a reasonable period of time, the Federal Reserve will lead the necessary examination activities in coordination with other relevant primary supervisors and functional regulators to the extent possible.

- *Additional required audit testing activities.* In all instances, the Federal Reserve will conduct testing activities as part of its audit infrastructure review (either by leading the activities and coordinating with other relevant primary supervisors or functional regulators or participating as actively as appropriate in activities led by other relevant supervisors or regulators) on at least a three-year cycle to ensure that the internal audit program is appropriately designed and achieving its objectives.

In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described above in section 1050.1.1.2.

#### *1050.1.3.1.2 Risk Management and Internal Control Functions for Primary Risks to the Consolidated Organization*

*Objectives:* Underlying the risk-focused approach to consolidated supervision of large complex BHCs is the premise that it is each organization's responsibility to develop an appropriate control structure for identifying, measuring, monitoring, and controlling key risks as measured against supervisory standards and expectations, applicable laws and regulations, and evolving practices of well-managed organizations.

The Federal Reserve will understand and assess risk-management and control functions for primary risks to the consolidated organization (primary firmwide risk-management and control functions), and associated MIS, for each large complex BHC. This will include risk-management and control functions for primary

credit, legal and compliance,<sup>10</sup> liquidity, market, operational, and reputational risks for the consolidated organization. The Federal Reserve also will understand and assess other risk-management and control functions that, based on the specific characteristics and activities of the individual BHC, relate to primary risks to the organization as a whole.

For example, for large complex BHCs with particularly dynamic corporate strategies, the Federal Reserve will understand and assess the adequacy of the control mechanisms relevant to such strategies, including strategic planning, merger integration, new business approval, and processes for ensuring that risk management and controls keep pace with areas of growing inherent risk. Furthermore, large complex BHCs operating across a range of financial intermediary activities are more likely to face potential conflicts of interest due to their greater likelihood of acting as agents for both issuers and investors. For these holding companies, it is necessary to assess the adequacy of processes for identifying and avoiding or managing conflicts of interest.

In all instances, the adequacy of each primary firmwide risk management or control mechanism depends on the appropriateness of the following:

1. control infrastructure and governance, including degree of oversight by the board and senior management;
2. development, maintenance, and communication of appropriate policies, procedures, and internal controls;
3. risk identification and measurement systems and processes, and associated MIS, that are adaptive to changing circumstances and capable of providing timely, accurate, and comprehensive information to senior management and the board;
4. monitoring and testing the effectiveness of controls;
5. processes for identifying, reporting, and escalating issues and emerging risks;
6. ability to implement corrective actions in a timely manner;

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nation led by another primary supervisor or functional regulator includes having input into determining the examination objectives, final conclusions, and related communications to the organization's management. In the event that a material aspect of the Federal Reserve's input is not reflected in the examination's objectives, conclusions, or related communications with the organization, the Federal Reserve will review the situation to determine whether additional steps are appropriate to address any remaining concerns.

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10. Federal Reserve processes for understanding and assessing legal and compliance risk management apply to the domestic and international operations of large complex BHCs and, as described in SR-03-22/CA-03-15, "Framework for Assessing Consumer Compliance Risk at Bank Holding Companies," (see section 2124.01) encompass consumer compliance risk inherent in the organization's business activities.

7. appropriate authority and independence of staff to carry out responsibilities; and
8. integration of risk-management and control objectives within management goals and the organization's compensation structure.

Most large complex BHCs have evolved toward comprehensive, consolidated risk management to measure and assess the range of their exposures and the way these exposures interrelate. Nonetheless, a variety of control structures are in place across this portfolio, and in some instances there is not a firmwide mechanism in place to oversee and manage a key control function across the organization's business lines and legal entities.

In all instances, the Federal Reserve will focus on individual control structures in place for primary business lines or legal entities as needed to reach an understanding and assessment of the consolidated organization. When applicable, the Federal Reserve also will assess whether a decentralized approach to a key control function is sufficient by evaluating the effectiveness of such an approach in controlling primary risks to the consolidated organization.<sup>11</sup>

***Supervisory Activities:*** The Federal Reserve will use continuous monitoring activities to understand and assess each primary firmwide risk-management or control function. This process begins with the overarching design and architecture of each primary firmwide risk-management or control function, and drills down, as appropriate, through analysis of risk management and controls for material portfolio areas and business lines (described in section 1050.1.3.1.3 below). Activities will verify the sufficiency of

fundamental aspects of internal controls in relation to the holding company's current risk profile and in comparison with supervisory expectations and evolving sound practices and assess the capability of these primary functions (whether centralized or decentralized) to remain effective in the face of growth, changing strategic direction, significant market developments, and other internal or external factors.

The results of continuous monitoring activities, as documented in the institutional overview, risk assessment, and other supervisory products, may identify certain primary firmwide risk-management or control functions that require more intensive supervisory focus due to (1) significant changes in inherent risk, control processes, or key personnel; (2) potential concerns regarding the adequacy of controls; or (3) the absence of sufficiently recent examination activities for a primary firmwide risk-management or control function by the Federal Reserve or another relevant primary supervisor or functional regulator.

In these instances, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) to develop discovery reviews or testing activities focusing on the area of concern. In situations where another primary supervisor or functional regulator leads the examination activities, the Federal Reserve will participate as actively as appropriate in those activities.

If the primary firmwide risk-management or control function is not within the oversight of another primary supervisor or functional regulator, or if the primary supervisor or functional regulator does not conduct or coordinate the examination activities in a reasonable period of time, the Federal Reserve will lead the necessary examination activities in coordination with other relevant supervisors and regulators to the extent possible. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described above in section 1050.1.1.2.

#### *1050.1.3.1.3 Risk Management of Material Portfolios and Business Lines*

***Objectives:*** For each large complex BHC, there are selected portfolio risk areas (such as retail or wholesale credit risk) or individual business lines (such as mortgage lending or leveraged lending) that are primary drivers of risk or revenue, or that otherwise materially contribute to understanding inherent risk or assessing con-

11. As outlined in SR-08-8/CA-08-11, "Compliance Risk-Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles" (see section 2124.07), while the Federal Reserve does not prescribe a particular organizational structure for primary firmwide risk-management and control functions, establishment of a firmwide function that is dedicated to managing and overseeing compliance risk, and that promotes a strong compliance culture, is particularly important for large banking organizations with complex compliance profiles, due to the unique challenges associated with compliance risk management for these organizations. In addition to the oversight provided by the board and various executive and management committees, a key component of firmwide compliance oversight for these organizations is a corporate compliance function that has day-to-day responsibility for overseeing and supporting the implementation of the organization's firmwide compliance risk-management program, and that plays a key role in controlling compliance risks that transcend business lines, legal entities, and jurisdictions of operation.

trols for a broader corporate function (such as consolidated credit-risk management).

During the development of the institutional overview and risk assessment, as well as during other supervisory processes, the Federal Reserve will analyze external factors and internal trends in the BHC's strategic initiatives—as evidenced by budget and internal capital allocations and other factors—to identify significant activities and areas vulnerable to volatility in revenue, earnings, capital, or liquidity that represent material risks of the organization. This determination of material portfolios and business lines considers all associated risk elements, including legal and compliance risks. For example, when evaluating whether retail activities such as mortgage or credit card lending are material to a banking organization, the extent of inherent consumer compliance and reputational risks, as well as credit and market risks, should be considered.

*Supervisory Activities:* Because an understanding of material risks and activities is needed to assess the primary firmwide risk-management and control functions (as discussed in preceding section 1050.1.3.1.2), the Federal Reserve will maintain an understanding of inherent risk and assess the adequacy of risk-management and internal controls for material portfolios and business lines. To form this understanding and assessment, the Federal Reserve will rely primarily on continuous monitoring activities, supplemented as appropriate by examination activities.

To the fullest extent possible, the Federal Reserve will draw its understanding and assessment of these risks and risk-management practices from the information and assessments of a primary supervisor or functional regulator where the BHC's legal and operating structure provides the supervisor or regulator a sufficient view of these areas. In these instances, the Federal Reserve will undertake continuous monitoring and participate in activities led by primary supervisors and functional regulators as necessary to maintain an understanding and assessment of related firmwide risk-management and control functions.

Many activities of large complex BHCs span legal entities that are subject to oversight by multiple supervisors or regulators or that are outside the oversight of other supervisors or regulators. If this is the case, or if the primary supervisor or functional regulator does not conduct or coordinate the necessary continuous monitoring or examination activities in a reasonable period of time, the Federal Reserve will initiate and lead these activities in coordination with other relevant primary supervisors and

functional regulators to the extent possible. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described above in section 1050.1.1.2.

#### *1050.1.3.1.4 Risk Management of Nonmaterial Business Lines*

*Objectives:* For nonmaterial business lines identified during the development of the institutional overview and risk assessment, as well as during other supervisory processes, the Federal Reserve's focus will be on identifying and understanding those business lines that are increasing in importance and have the potential to become material.

*Supervisory Activities:* When a primary supervisor or functional regulator has a sufficient view of nonmaterial business lines, the Federal Reserve will, to the fullest extent possible, use information developed by that supervisor or regulator to monitor areas of increasing importance with the potential to become material. The Federal Reserve also will maintain an ability to access internal MIS for these businesses to facilitate a more in-depth analysis of a business line, if appropriate, to understand its growing importance to the organization.

For nonmaterial business lines that are not subject to oversight by a single primary supervisor or functional regulator, the Federal Reserve will engage in continuous monitoring activities to identify meaningful trends in risks and risk-management practices, initiate discovery reviews (in coordination with relevant primary supervisors or functional regulators as appropriate and in accordance with section 1050.1.1.2 above if relevant) to increase understanding of selected business lines that have the potential to become material, and maintain an understanding of associated MIS to facilitate more in-depth analysis of a business line, if appropriate, to understand its growing importance to the organization.

#### *1050.1.3.1.5 Core Clearing and Settlement Activities (Where Applicable)*

*Objectives:* The Federal Reserve will understand and assess the adequacy of risk-management and internal controls—including credit risk-management practices—related to core

clearing and settlement organizations.<sup>12</sup> In light of the potential for problems in these areas to transmit an adverse impact across the banking and financial system, and given the Federal Reserve's unique expertise and perspective with respect to these activities, the Federal Reserve focuses special supervisory attention on the risk-management and internal control practices and the public disclosures made by an organization with respect to these activities.

**Supervisory Activities:** Continuous monitoring and examination activities will be used to maintain an understanding of inherent risk and assess risk-management and internal controls, including related credit risk-management practices. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there is (1) a significant change in inherent risk for core clearing and settlement activities stemming from changing strategies or activities; (2) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk-management or internal controls; or (3) any potential concern regarding the adequacy of related risk-management or internal controls.

If significant changes or potential concerns are identified, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) to design testing activities focused on understanding and assessing areas of change and/or concern, as well as ensure that risk-management and control functions are appropriately designed and achieving their intended objectives. In situations where another primary supervisor or functional regulator leads the discovery review or testing activi-

ties, the Federal Reserve will participate as actively as appropriate in those activities.

If the area of change and/or concern is not within the oversight of another primary supervisor or functional regulator, or if the primary supervisor or functional regulator does not conduct or coordinate the examination activities in a reasonable period of time, the Federal Reserve will lead the examination activities in coordination with other relevant primary supervisors and functional regulators to the extent possible.

In all instances, the Federal Reserve will conduct testing activities (either by leading the activities and coordinating with other relevant primary supervisors or functional regulators, or participating as actively as appropriate in activities led by other relevant supervisors or regulators) on at least a three-year cycle to ensure that these control mechanisms are appropriately designed and achieving their objectives. In addition to assessing the adequacy of risk-management and internal controls, testing activities will focus on assessing the contribution of the organization to the resilience or fragility of the clearance and settlement system as a whole, and on the organization's adherence to the expectations of the interagency sound practices paper. Key expectations include geographic diversity and resiliency of data centers and operations, testing of recovery and resumption arrangements, and identification of downstream implications of failure of a major counterparty or clearing organization.

In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.1.1.2.

#### *1050.1.3.1.6 Significant Presence in Critical Financial Markets (Where Applicable)*

**Objectives:** The Federal Reserve will understand and assess the adequacy of risk management and controls for LCBO business lines with a significant presence in critical financial markets.

"Critical financial markets" are defined in the interagency sound practices paper as the markets for federal funds, foreign exchange, and commercial paper; U.S. government and agency securities; and corporate debt and equity securities. A business line may have a significant presence in a critical financial market even though the business line accounts for a relatively small portion of the organization's total consolidated assets or revenues. These business

12. Core clearing and settlement organizations, as defined in the *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System* (interagency sound practices paper, see SR-03-9), consist of two groups of organizations that provide clearing and settlement services for critical financial markets or act as large-value payment system operators, and that present the potential for systemic risk should they be unable to perform. These organizations are (1) market utilities (government-sponsored services or industry-owned organizations) whose primary purpose is to clear and settle transactions for critical markets (see section 1050.1.3.1.6) or transfer large-value wholesale payments, and (2) private-sector firms that provide clearing and settlement services that are integral to a critical market (i.e., their aggregate market share is significant enough to present the potential for systemic risk in the event of their sudden failure to carry out those activities because there are no viable immediate substitutes).

lines are subject to special supervisory focus by the Federal Reserve in light of their potential to transmit a collective adverse impact across multiple firms and financial markets and the resulting significant reputational and other risks they pose to the organization.

*Supervisory Activities:* Continuous monitoring and examination activities will be used to understand inherent risk and assess risk-management and internal controls for business lines with a significant presence in a critical financial market. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there is (1) a significant change in inherent risk stemming from changing strategies or activities; (2) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk-management or internal controls; or (3) any potential concern regarding the adequacy of related risk-management or internal controls.

If significant changes or potential concerns are identified in these business lines, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) to design testing activities focused on understanding and assessing areas of change and/or concern, as well as ensure that risk-management and control functions are appropriately designed and achieving their intended objectives. In situations where another primary supervisor or functional regulator leads the testing activities, the Federal Reserve will participate as actively as appropriate in those activities.

If the area of change and/or concern is not within the oversight of another primary supervisor or functional regulator, or if the primary supervisor or functional regulator does not conduct or coordinate the examination activities in a reasonable period of time, the Federal Reserve will lead the testing activities and will coordinate these activities with other relevant primary supervisors and functional regulators to the extent possible.

In all instances, the Federal Reserve will conduct testing activities (either by leading the activities and coordinating with other relevant primary supervisors or functional regulators, or participating as actively as appropriate in activities led by other relevant supervisors or regulators) on at least a three-year cycle. These activities will focus on the organization's adherence to the expectations set forth in the interagency sound practices paper, including geographic diversity and resiliency of data centers and

operations, and testing of recovery and resumption arrangements.

In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.1.1.2.

#### *1050.1.3.1.7 Risk Management of Activities in Key Financial Markets*

*Objectives:* To be designated as an LCBO by the Federal Reserve, a banking organization must meet specified criteria as a significant participant in at least one key financial market.<sup>13</sup> For each key financial market activity where the large complex BHC is a significant participant, the Federal Reserve will maintain an understanding of inherent risk, assess the adequacy of related risk-management and internal controls (including the sufficiency of business continuity planning), and understand the organization's potential impact on the overall functioning of the market.

*Supervisory Activities:* Continuous monitoring and examination activities will be used to understand inherent risk for key financial market activities and assess related risk-management and internal controls.

To the fullest extent possible, the Federal Reserve will draw its understanding and assessment of these risks and risk-management practices from the information and assessments of a primary supervisor or functional regulator where the BHC's legal and operating structure provides the supervisor or regulator a sufficient view of these areas. In these instances, the Federal Reserve will undertake continuous monitoring and participate in activities led by primary supervisors and functional regulators as necessary to maintain an understanding and assessment of risk-management and control functions for key financial market activities.

For activities that span legal entities subject to oversight by multiple supervisors or regulators, or that are outside the oversight of other supervisors or regulators, the Federal Reserve will develop and conduct—in coordination with

13. "Key financial markets" include the critical financial markets defined in section 1050.1.3.1.6 above as well as (1) broader U.S. capital market activity, including underwriting, securitization, derivatives, and trading; (2) retail financial services; and (3) international financial markets. Each LCBO meets at least one of these key market thresholds.

other relevant primary supervisors and functional regulators to the extent possible and in accordance with the provisions described above in section 1050.1.1.2 if relevant—testing and discovery review activities as necessary to complement continuous monitoring work.

#### *1050.1.3.1.8 Issues and Developments in Areas of Emerging Interest with Potential Financial Market Consequences*

**Objectives:** The Federal Reserve will use information obtained in the course of supervising LCBOs, as well as information and analysis obtained through relationships with other domestic and foreign supervisors and regulators or other sources, to

1. identify potential vulnerabilities across the portfolio of LCBOs and their nonbank peers—such as the operational infrastructure that underpins the credit derivatives market—that have the potential to affect banking organizations generally, financial stability, systemic risk, or domestic or global financial markets;
2. identify areas of supervisory focus—such as counterparty credit risk-management practices—to further the Federal Reserve’s understanding of markets, their linkages with banking organizations, and potential implications for financial stability;
3. understand the activities of nonbank counterparties of LCBOs and the implications of such activities on the risks, risk management, and internal controls of banking organizations; and
4. enhance the Federal Reserve’s ability to act effectively during periods of financial stress by combining timely and reliable information on conditions in the banking system and capital markets that is obtained through its supervisory activities with information obtained through the Federal Reserve’s monetary policy and payments activities.

**Supervisory Activities:** During each supervisory planning cycle, and more frequently as required, continuous monitoring opportunities will be identified that utilize information gained through LCBO supervision to further the Federal Reserve’s understanding of risks and activities that could adversely affect LCBOs or the stability of domestic or global financial markets.

Activities will include meetings with chief risk officers, chief financial officers, and other LCBO senior management, as well as collaboration with other domestic and foreign supervisors and regulators and foreign central banks.

These activities also will be used to review areas of specific supervisory interest; answer ad hoc information requests related to areas of emerging interest or concern; help in understanding the contribution of the entity to the resilience or fragility of key markets as a whole; and provide insights into interdependencies across firms, markets, and the real economy. During periods of financial stress, this information will be combined with knowledge obtained from other Federal Reserve functions, such as monetary policy and payments activities, to help mitigate the likelihood or consequences of a financial crisis and to help develop sound policy responses to market developments. Periodic examination activities also may be used to review a specific activity or risk-management practice across a group of peer organizations to obtain a more complete understanding of industry practice.<sup>14</sup>

These activities will be designed and conducted in coordination with other relevant primary supervisors and functional regulators to the fullest extent possible and in accordance with the provisions described above in section 1050.1.1.2, where relevant. Coordination opportunities, however, may be limited in special circumstances, such as when addressing urgent matters with potentially adverse financial market consequences, due to the inherent time constraints when information must be gathered quickly.

#### **1050.1.3.2 Financial Condition**

**Objectives:** The Federal Reserve’s evaluation of a large complex BHC’s consolidated financial condition focuses on the ability of the organization’s resources to support the level of risk associated with its activities. Assessments are developed for each “CAEL” subcomponent—Capital Adequacy (C), Asset Quality (A), Earnings (E), and Liquidity (L).<sup>15</sup>

In developing this evaluation, the Federal Reserve’s primary focus is on developing an understanding and assessment of

14. In order to minimize burden while obtaining information necessary to understand market developments, these activities will focus on those organizations that are most active in the area of interest or concern.

15. See SR-04-18 and section 4070.0.2.3.1 for more information about the CAEL subcomponents.

1. the sufficiency of the BHC's consolidated capital to support the level of risk associated with the organization's activities and provide a sufficient cushion to absorb unanticipated losses;
2. the capability of liquidity levels and funds-management practices to allow reliable access to sufficient funds to meet present and future liquidity needs; and
3. other aspects of financial strength that need to be assessed on a consolidated basis across the organization's various legal entities, or that relate to the financial soundness of the parent company and significant nonbank subsidiaries, as discussed in section 1050.1.3.3 below.

In assessing consolidated regulatory capital, the Federal Reserve looks to ensure that the BHC demonstrates the effectiveness of its framework for complying with relevant capital adequacy guidelines and meeting supervisory expectations, and focuses on analyzing key models and processes<sup>16</sup> that influence this assessment. This assessment utilizes results from examinations led by the Federal Reserve or other primary supervisors or functional regulators, as well as information gained from the BHC's internal control functions and from market-based assessments.

Capital planning activities for large complex BHCs should be forward looking and provide for a sufficient range of stress scenarios commensurate with the organization's activities. Many LCBOs require more rigorous and structured internal processes for assessing capital adequacy beyond regulatory capital measures, as these measures often do not adequately capture the full spectrum of risk-taking activities for these organizations.<sup>17</sup> For these organizations, the Federal Reserve focuses on whether internal processes for assessing capital adequacy ensure that all risks are properly identified, reliably quantified (where possible) across the entire organization, and supported by adequate capital.

When assessing the adequacy of a BHC's liquidity levels and funds management practices, areas of focus include<sup>18</sup>

1. the extent to which the treasury function is aligned with risk-management processes, and whether incentives are in place for business lines to compile and provide information on expected liquidity needs and contingency funding plans so that the treasury function is able to develop a firmwide perspective and incorporate business-line information into assessments of actual and contingent liquidity risk;
2. whether funds management practices provide sufficient funding flexibility to respond to unanticipated, evolving, and potentially correlated market conditions for the organization and/or across financial markets; and
3. the sufficiency of liquidity planning tools, such as stress testing, scenario analysis, and contingency planning efforts, including (1) whether liquidity buffers—comprised of unencumbered liquid assets as well as access to stable funding sources—adequately reflect the possibility and duration of severe liquidity shocks; (2) the reasonableness of assumptions about the stability of secured funding in circumstances in which the liquidity of markets for the underlying collateral becomes impaired; and (3) whether these efforts adequately reflect the potential for the organization to be called on in stressed environments to provide contingent liquidity support to off-balance-sheet entities or bring additional assets on the balance sheet (even if not legally or contractually obligated to do so).

Beyond capital adequacy and liquidity, the nature of independent Federal Reserve supervisory work required to evaluate a large complex BHC's consolidated financial condition depends largely on the extent to which other relevant primary supervisors or functional regulators have information or assessments upon which the Federal Reserve can draw. For example, more independent Federal Reserve work typically will be required to assess consolidated asset quality or earnings for large complex BHCs with significant nonbank activities that are not functionally regulated. However, where all material holding company assets are concentrated in a single depository institution subsidiary, a minimal level of incremental Federal Reserve efforts typically will be required to assess consolidated asset quality and earnings.

16. "Key models and processes" are those where evaluation of the model/process will influence the Federal Reserve's assessment of the activity or control area that is supported by the model/process.

17. Footnote reserved.

18. Assessing liquidity levels and funding practices for a consolidated BHC also incorporates elements presented in section 1050.1.3.3.2, "Parent company and nonbank funding and liquidity."

*Supervisory Activities:* The Federal Reserve will primarily utilize continuous monitoring activities to assess a large complex BHC's financial strength. Such activities will include periodic meetings with BHC management (such as the chief financial officer); review of regulatory reports, surveillance screens, and internal MIS; and analysis of market indicators, including external debt ratings, subordinated debt spreads, and credit default swap spreads. Testing and discovery activities will be used as necessary to assist in the understanding and assessment of areas of concern.

Testing and discovery activities also will be used to understand and assess the sufficiency of the BHC's consolidated capital and liquidity positions to support the level of risk associated with its activities, including (1) regulatory capital calculation methodologies<sup>19</sup> and internal assessments of capital adequacy and (2) funds management and liquidity planning tools and practices. The Federal Reserve will work with other relevant primary supervisors and functional regulators to participate as actively as appropriate in or, if necessary, to coordinate activities designed to analyze key capital and liquidity models or processes of a depository institution or functionally regulated subsidiary that are of such significance that they will influence the Federal Reserve's assessment of these areas. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.1.1.2.

### 1050.1.3.3 Impact

#### *1050.1.3.3.1 Risk Management and Financial Condition of Significant Nonbank Subsidiaries*

*Objectives:* Most large complex BHCs engage in activities and manage control functions on a

firmwide basis, spanning depository institution and nonbank legal entities. These BHCs often have considerable intra-group exposures and servicing arrangements across affiliates, presenting increased potential risks for depository institution subsidiaries and a higher likelihood of aggregate risk concentrations across the organization's legal entities. Common interactions between a large complex BHC's depository institution subsidiaries and their nonbank affiliates (including the parent company) include assets originating in, or being marketed by, a nonbank affiliate that are booked in the depository institution; a depository institution providing funding for nonbank affiliates; and risk-management or internal control functions being shared between depository and nonbank operations.

Due to these interrelationships, financial, legal, compliance, or reputational troubles in one part of a BHC can spread rapidly to other parts of the organization. Even absent these interactions, the parent or nonbank subsidiaries of an organization may present financial, legal, compliance, or reputational risk to the consolidated entity, and thus directly or indirectly to its depository institution subsidiaries. As the federal banking agency charged with supervising the organization on a consolidated basis, the Federal Reserve is responsible for understanding and assessing the risks that the parent bank holding company and its nonbank subsidiaries may pose to the BHC itself or its depository institution subsidiaries.

The primary objectives of Federal Reserve supervision of the nonbank subsidiaries of a bank holding company are to

1. identify significant nonbank activities and risks—where the parent company or nonbank subsidiaries engage in risk-taking activities or hold exposures that are material to the risk management or financial condition of the consolidated organization or a depository institution subsidiary—by developing an understanding of the size and nature of primary activities and key trends, and the extent to which business lines, risks, or control functions are shared with or may impact a depository institution affiliate;
2. evaluate the financial condition and the adequacy of risk-management practices of the parent and significant nonbank subsidiaries, including the ability of nonbank subsidiaries to repay advances provided by the parent, using benchmarks and analysis appropriate for those businesses;

19. Assessments of the adequacy of regulatory capital for large complex BHCs that have received Federal Reserve supervisory approval to use internal estimates of risk in their regulatory capital calculations should include, among other things, regular verification that these organizations continue to meet on an ongoing basis all applicable requirements associated with internal estimates. See, for example, the capital adequacy guidelines for market risk at BHCs (Regulation Y: 12 C.F.R. 225, Appendix E) and the new advanced capital adequacy framework for BHCs (Regulation Y: 12 C.F.R. 225, Appendix G).

3. evaluate the degree to which nonbank entity risks may present a threat to the safety and soundness of subsidiary depository institutions, including through transmission of legal, compliance, or reputational risks;
4. identify and assess any intercompany relationships, dependencies, or exposures—or aggregate firmwide concentrations—with the potential to threaten the condition of a depository institution affiliate; and
5. evaluate the effectiveness of the policies, procedures, and systems that the holding company and its nonbank subsidiaries use to ensure compliance with applicable laws and regulations, including consumer protection laws.<sup>20</sup>
6. identify significant businesses operated across multiple legal entities for accounting, risk management, or other purposes, as well as activities that functionally operate as separate business units for legal or other reasons;
7. identify intercompany transactions subject to Regulation W—utilizing information submitted on quarterly regulatory reporting form FR Y-8 (“The Bank Holding Company Report of Insured Depository Institutions’ Section 23A Transactions with Affiliates”), internal MIS, and other information sources—and determine (in conjunction with the primary supervisor) whether compliance issues are present; and
8. understand and assess the sufficiency, reliability, and timeliness of associated MIS relied upon by the board, senior management, and senior risk managers and committees to monitor key nonbank activities and risks.

*Supervisory Activities:* For all significant nonbank subsidiaries and activities of the parent BHC, the Federal Reserve will use continuous monitoring activities and discovery reviews to

1. maintain an understanding of the holding company’s business line and legal entity structure, including key interrelationships and dependencies between depository institution subsidiaries and nonbank affiliates, utilizing regulatory structure reports, internal MIS, and other information sources;
2. understand and assess the exposure to, and tolerance for, legal, compliance, and reputational risks, as well as the extent to which potential conflicts of interest are identified and avoided or managed;
3. understand the scope of intercompany transactions and aggregate concentrations, and assess the adequacy of risk-management processes, accounting policies, and operating procedures to measure and manage related risks;
4. identify and assess key interrelationships and dependencies between subsidiary depository institutions and nonbank affiliates, such as the extent to which a depository institution subsidiary is reliant on services provided by the parent company or other nonbank affiliates and the reasonableness of associated management fees;
5. identify those nonbank subsidiaries whose activities present material financial, legal, compliance, or reputational risk to the consolidated entity and/or a depository institution subsidiary;

Periodic testing may be used to supplement continuous monitoring and discovery reviews to (1) ensure that key risk-management and internal control practices conform to internal policies and/or are designed to ensure compliance with the law and (2) understand and assess operations presenting a moderate or greater likelihood of significant negative impact to a subsidiary depository institution or the consolidated organization. Areas of potential negative impact include financial or operational risks that pose a potential threat to the safety and soundness of a depository institution subsidiary, or to the holding company’s ability to serve as a source of financial and managerial strength to its depository institution subsidiaries. Testing will focus on controls for identifying, monitoring, and controlling such risks. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.1.1.2.

#### *1050.1.3.3.2 Parent Company and Nonbank Funding and Liquidity*

*Objectives:* One of the Federal Reserve’s primary responsibilities as consolidated supervisor is to help ensure that the parent company and its nonbank subsidiaries do not have an adverse impact on the organization’s depository institution subsidiaries. To meet this objective, the

20. The Federal Reserve’s supervisory objectives and activities related to the effectiveness of consumer compliance policies, procedures, and systems at nonbank subsidiaries of a BHC currently are under review, and additional or modified guidance on this topic may be issued in the future.

Federal Reserve will assess the extent to which funding and liquidity policies and practices of the parent company or nonbank subsidiaries may undermine the BHC's ability to act as a source of strength to the organization's depository institution subsidiaries.

Areas of focus will include an assessment of

1. the ability of the parent company and nonbank subsidiaries to maintain sufficient liquidity, cash flow, and capital strength to service their debt obligations and cover fixed charges;
2. the likelihood that parent company or nonbank funding strategies could undermine public confidence in the liquidity or stability of subsidiary depository institutions;
3. policies and practices that are aimed at ensuring the stability of parent company funding and liquidity, as evidenced by the utilization of long-term or permanent financing to support capital investments in subsidiaries and other long-term assets, and the degree of dependence on short-term funding mechanisms such as commercial paper;
4. the extent of "double leverage"<sup>21</sup> and the organization's capital-management policies, including the distribution and transferability of capital across jurisdictions and legal entities;
5. the parent company's ability to provide financial and managerial support to its depository institution subsidiaries during periods of financial stress or adversity, including the sufficiency of related stress testing, scenario analysis, and contingency planning efforts; and
6. intraday liquidity management policies and practices, and compliance with the "Federal Reserve Policy on Payments System Risk,"<sup>22</sup> including expectations for depository institutions with a self-assessed net debit cap (the maximum dollar amount of uncollateralized daylight overdrafts that the institution may incur in its Federal Reserve account).

The Federal Reserve also will remain apprised of the funding profile and market access of material depository institution subsidiaries, as in most instances these entities represent the consolidated BHC's primary and most active vehicles for external funding and liquidity management. The primary supervisor retains

responsibility for assessing liquidity risk-management practices with respect to the depository institution subsidiary.

*Supervisory Activities:* The Federal Reserve will use continuous monitoring activities—including monitoring market conditions and indicators where available—and discovery reviews to understand and assess parent company and nonbank subsidiary funding and liquidity policies and practices, as well as any potential negative impact these policies and practices might have on a subsidiary depository institution or the consolidated organization. On at least an annual basis, the results of these supervisory activities will be reviewed to determine whether there is (1) a significant change in inherent funding or liquidity risk stemming from changing strategies or activities; (2) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk-management or internal controls; or (3) any potential concern regarding the adequacy of related risk-management or internal controls.

If significant changes or potential concerns are identified, the Federal Reserve will design and conduct testing activities focused on understanding and assessing the areas of change and/or concern in order to ensure that funding and liquidity risk-management and control functions are appropriately designed and achieving their intended objectives.

In all instances the Federal Reserve will undertake testing activities on at least a three-year cycle, assessing the individual elements of risk management for parent company and nonbank funding and liquidity: board and senior management oversight; policies, procedures, and limits; risk-monitoring and management information systems; and related internal controls.

For large complex BHCs with a depository institution that has a self-assessed net debit cap, the Federal Reserve will conduct an annual review of the self-assessment file to ensure that the institution has appropriately applied the payment system risk guidelines. The Federal Reserve will either lead this review and coordinate its activities with other relevant primary supervisors or participate as actively as appropriate in the related work of such supervisors. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section 1050.1.1.2.

21. "Double leverage" refers to situations in which debt is issued by the parent company and the proceeds are invested in subsidiaries as equity.

22. This policy statement is available on the Board's public website at [www.federalreserve.gov/paymentsystems/psr](http://www.federalreserve.gov/paymentsystems/psr).

### 1050.1.4 INTERAGENCY COORDINATION

#### 1050.1.4.1 Coordination and Information Sharing Among Domestic Primary Bank Supervisors and Functional Regulators

*Objective:* Effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and other relevant domestic primary bank supervisors and functional regulators.<sup>23</sup> To achieve this objective, the Federal Reserve has worked over the years to enhance interagency coordination through the development and use of information-sharing protocols and mechanisms. These protocols and mechanisms respect the individual statutory authorities and responsibilities of the respective supervisors and regulators, provide for appropriate information flows and coordination to limit unnecessary duplication or burden, comply with restrictions governing access to information, and ensure that the confidentiality of information is maintained. For example, the Federal Reserve and the U.S. Securities and Exchange Commission entered into a memorandum of understanding (MOU) in July 2008 that, among other things, provides for the parties to share specific types of information concerning entities under the parties' respective supervision as well as information on other areas of mutual regulatory or supervisory interest.

As discussed in section 1050.1.3, in understanding and assessing the activities and risks of the organization as a whole, the Federal Reserve will rely to the fullest extent possible on the examination and other supervisory work conducted by the domestic primary bank supervisors and functional regulators of a BHC's subsidiaries. In addition, the Federal Reserve will seek to coordinate its supervisory activities with relevant supervisors and regulators and will work to align each agency's assessment of key corporate governance functions, risk-management and internal control functions for primary risks, financial condition, and other areas of the consolidated BHC's operations as applicable.

*Supervisory Activities.* The Federal Reserve will continue to work with the relevant primary supervisors and functional regulators of a large complex BHC's subsidiaries to ensure that the necessary information flows and coordination mechanisms exist to permit the effective supervision of the BHC on a consolidated basis. The

Federal Reserve will continue to share information, including confidential supervisory information, obtained or developed through its consolidated supervisory activities with other relevant primary supervisors or functional regulators when appropriate and permitted by applicable laws and regulations.<sup>24</sup>

The Federal Reserve also will continue to use a variety of formal and informal channels to facilitate interagency information sharing and coordination consistent with the principles outlined above, including

- supervisory protocols, agreements, and MOUs with primary supervisors and functional regulators that allow the coordination of supervisory activities and that permit the ongoing exchange of information, including confidential information on a confidential basis;
- bilateral exchanges of letters to facilitate information sharing on a situation-specific basis;
- periodic and as-needed contacts with primary supervisors and functional regulators to discuss and coordinate matters of common interest, including the planning and conduct of examinations and continuous monitoring activities;
- the use of information technology platforms, such as the Banking Organization National Desktop (BOND),<sup>25</sup> to provide secure automated access to examination/inspection reports and other supervisory information prepared by the Federal Reserve and other relevant supervisors and regulators; and
- participation in a variety of interagency forums that facilitate the discussion of broad industry issues and supervisory strategies, including the Federal Financial Institutions Examination Council, the President's Working Group on Financial Markets, and the Federal Reserve-sponsored cross-sector meetings of financial supervisors and regulators.

24. Among the federal laws that may limit the sharing of information among supervisors are the Right to Financial Privacy Act (12 U.S.C. 3401 et seq.) and the Trade Secrets Act (18 U.S.C. 1905). The Federal Reserve has established procedures to authorize the sharing of confidential supervisory information, and Federal Reserve staff must ensure that appropriate approvals are obtained prior to releasing such information. See Subpart C of the Board's Rules Regarding the Availability of Information (12 C.F.R. 261.20 et seq.).

25. BOND is a Federal Reserve information technology platform providing secure interagency access to documents, supervisory and financial data, and other information utilized in the consolidated supervision of individual BHCs and FBOs, and in developing comparative analyses of organizations with similar business lines and risk characteristics.

23. Section 1050.1.4.2 discusses cross-border cooperation and information sharing among foreign supervisors.

#### 1050.1.4.1.1 *Coordination of Examination Activities at a Supervised BHC Subsidiary*

As discussed in section 1050.1.3, the Federal Reserve will seek to work cooperatively with the relevant primary supervisor or functional regulator to address information gaps or indications of weakness or risk identified in a supervised BHC subsidiary that are material to the Federal Reserve's understanding or assessment of the consolidated organization's risks, activities, or key corporate governance, risk-management, or control functions. Prior to conducting discovery reviews or testing activities at a depository institution (other than where the Federal Reserve is the primary federal supervisor) or functionally regulated subsidiary of a BHC, the Federal Reserve will

- review available information sources as part of its continuous monitoring activities, including examination reports and the BHC's internal MIS, to determine whether such information addresses the Federal Reserve's information needs or supervisory concerns; and
- if needed, seek to gain a better understanding of the primary supervisor's or functional regulator's basis for its supervisory activities and assessment of the subsidiary. This may include a request to review related examination work.

If, following these activities, the Federal Reserve's information needs or supervisory concerns remain, the Federal Reserve will work cooperatively with the relevant primary supervisor or functional regulator in the manner discussed in section 1050.1.3 above.<sup>26</sup>

#### 1050.1.4.2 *Cooperation and Information Sharing With Host-Country Foreign Supervisors*

*Objectives:* Many large complex BHCs have considerable international banking and other operations that are licensed and supervised by foreign host-country authorities. As home-

country supervisor for domestic BHCs, the Federal Reserve is responsible for the comprehensive, consolidated supervision of these global organizations, while each host country is responsible for supervision of the legal entities (including foreign subsidiaries of U.S. BHCs) in its jurisdiction.

Information sharing among domestic and foreign supervisors, consistent with applicable laws, is essential to ensure that a large complex BHC's global activities are supervised on a consolidated basis. Cross-border information sharing is often facilitated by an MOU that establishes a framework for bilateral relationships and includes provisions for cooperation during the licensing process, in the supervision of ongoing activities, and in the handling of problem institutions. The Federal Reserve has established bilateral and multilateral information-sharing MOUs and other arrangements with numerous host-country foreign supervisors. The Federal Reserve also monitors changes in foreign bank regulatory and supervisory systems and seeks to understand how these systems affect supervised banking organizations. In addition to its longstanding cooperative relationships with home- and host-country foreign supervisors, the Federal Reserve expects to increasingly lead and participate in "colleges of supervisors" and other multilateral groups of supervisors that discuss issues related to specific internationally active banking organizations.

The Federal Reserve also is a member of the Basel Committee on Banking Supervision, which is a forum for supervisors from member countries to discuss important supervisory issues, foster consistent supervision of organizations with similar business and risk profiles, promote the sharing of leading supervisory practices, and formulate guidance to enhance and refine banking supervision globally.

The Federal Reserve's processes for understanding and assessing firmwide legal and compliance risk management, as described earlier, encompass both domestic and international operations. Most areas of supervisory focus for management of legal and compliance risks are applicable to both domestic and international entities, and include proper oversight of licensed operations, compliance with supervisory and regulatory requirements, and the sufficiency of associated MIS.

There are, however, areas of focus for the Federal Reserve that are unique to a holding company's international operations. For example, some host-country legal and regulatory structures and supervisory approaches are fundamentally different from those in the United

26. As outlined in section 1050.1.3, certain Federal Reserve examination activities are to be conducted on a minimum three-year cycle to verify, through testing, the sufficiency of key control processes. These activities are to be conducted regardless of whether or not there is an information gap or indication of weakness or risk.

States. As a result, the banking organization often must devote additional resources to maintain expertise in local regulatory requirements. In some instances, privacy concerns have led to limits on the information a BHC's foreign office may share with its parent company, thereby limiting the parent company's ability to exercise consolidated risk management on a global basis.

Additionally, while considerable progress has been made to strengthen supervisory cross-border cooperation and information sharing, the Federal Reserve and other U.S. supervisors have, at times, faced challenges in accessing information on a bank's or BHC's foreign operations or in carrying out examinations of cross-border or foreign activities. These circumstances are to be taken into account when developing a supervisory strategy for a large complex BHC with cross-border or foreign operations.

***Supervisory Activities:*** Continuous monitoring will be used to understand and assess each large complex BHC's international strategy, trends, operations, and legal entity structure, as well as related governance, risk-management, and internal controls. For a large complex BHC with significant international operations or risks, an assessment of cross-border and foreign operations will be incorporated into the evaluation of key corporate governance functions and primary firmwide risk-management and internal control functions, including legal and regulatory risk management.

Continuous monitoring activities will include review of materials prepared by host-country supervisors, including examination reports and assessments, and ongoing communication with relevant foreign and domestic supervisors regarding trends and assessments of cross-border and foreign operations. These continuous monitoring activities may be supplemented, as appropriate, by examination activities to understand and assess the large complex BHC's international strategy, trends, operations, and legal entity structure, as well as related governance, risk-management, and internal controls.

When assessing the sufficiency of a large complex BHC's management of its international operations, consideration is given to the extent that foreign laws restrict the transmission of information to the BHC's head office. Impediments to sharing information imposed by a host country may constrain the BHC's ability to effectively oversee its international operations and globally manage its risks, and the materiality of such impediments should be a determinant of whether the organization should be conducting operations in that host country.

In addition, any limits placed on the Federal Reserve's ability to access information on host-country operations, or to engage in onsite activities at the organization's operations in the host country, should be considered when assessing whether the organization's activities in that jurisdiction are appropriate.

#### 1050.1.4.3 Indications of Weakness or Risk Related to Subsidiary Depository Institutions

***Objectives:*** For areas beyond those specifically addressed in section 1050.1.3, there may be circumstances where the Federal Reserve has indications of material weakness or risk in a depository institution subsidiary of a BHC that is supervised by another primary supervisor, and it is not clear that the weakness or risk is adequately reflected in the assessment or supervisory activities of that supervisor. Because a primary objective of consolidated supervision is to protect the BHC's depository institution subsidiaries, the Federal Reserve will follow up with the appropriate primary supervisor in these circumstances to help ensure that, to the extent that a material weakness or risk exists, it is addressed appropriately.

***Supervisory Activities:*** The Federal Reserve will take the following steps if it has indications of material weakness or risk in a depository institution subsidiary (other than where the Federal Reserve is the primary federal supervisor) in an area beyond those specifically addressed in section 1050.1.3, and it is not clear that the weakness or risk is adequately reflected in the assessment or supervisory activities of the depository institution's primary supervisor.

- The Federal Reserve will first review available information sources, discuss the areas of concern with the primary supervisor, and seek to review the supervisor's related work.
- If concerns remain following these activities, the Federal Reserve will request that the primary supervisor conduct a discovery review or testing activity at the depository institution to address the area of concern.
- In the event the primary supervisor does not undertake activities to address the concern in a reasonable period of time, the Federal Reserve will design and lead an examination of the depository institution to address the matter in

consultation with the primary supervisor. A senior Federal Reserve official will communicate this decision in writing to a senior official of the primary supervisor.

#### 1050.1.4.4 Condition or Management of BHC Subsidiary is Less-than-Satisfactory

*Objectives:* As noted above, a primary responsibility of the Federal Reserve as consolidated BHC supervisor is to ensure that a holding company's activities, policies, and practices do not undermine its ability to serve as a source of financial and managerial strength to its depository institution subsidiaries. In situations where the condition or management of a supervised or functionally regulated BHC subsidiary is determined to be less-than-satisfactory, the Federal Reserve's focus as consolidated supervisor is on complementing the efforts of the primary supervisor or functional regulator. In doing so, the Federal Reserve will seek to ensure that the parent company provides appropriate support to the subsidiary and does not take actions that may further weaken the parent company's depository institution subsidiaries or its ability to act as a source of strength for such subsidiaries.

Beyond the specific activities noted below, these circumstances also may require the Federal Reserve to enhance the activities addressed in section 1050.1.3 for understanding and assessing key corporate governance functions or primary firmwide risk-management and internal controls. In addition, the Federal Reserve will adjust its supervisory activities as necessary when the consolidated BHC is in weakened condition or when there are questions regarding the capabilities of the holding company's management.

#### *Supervisory Activities:*

- *Depository institution subsidiary.* In instances when a depository institution subsidiary's condition or management is rated less than satisfactory, or when the depository institution subsidiary otherwise faces financial stress or material risks, the Federal Reserve's primary supervisory objectives as consolidated supervisor are to ensure that the parent company (1) provides appropriate support to the depository institution and (2) does not take action that could harm the depository institution. The

Federal Reserve will work closely with the primary supervisor to understand whether the BHC or a nonbank affiliate has contributed to the depository institution's weakened condition, to understand the impact of the depository institution on the BHC's condition, and to determine if the holding company is providing appropriate support to the depository institution. The Federal Reserve will coordinate its activities with those of the primary supervisor to the extent appropriate.

- *Nonbank subsidiary.* When any nonbank subsidiary faces financial stress or material risks, the Federal Reserve will seek to ensure that its condition and activities do not jeopardize the safety and soundness of the BHC or its depository institution subsidiaries, as discussed above in sections 1050.1.3.3.1, "Risk Management and Financial Condition of Significant Nonbank Subsidiaries" and 1050.1.3.3.2, "Parent Company and Nonbank Funding and Liquidity." The Federal Reserve also will take appropriate steps to ensure that any actions taken by the parent company to assist a nonbank subsidiary do not impair the BHC's continuing ability to serve as a source of strength to its depository institution subsidiaries. The Federal Reserve will coordinate its activities with those of any relevant functional regulator to the extent appropriate.

#### 1050.1.4.5 Edge and Agreement Corporations

*Objectives:* Many large complex BHCs control an Edge or agreement corporation subsidiary. The Federal Reserve serves as the primary supervisor of each Edge and agreement corporation subsidiary in addition to its role as consolidated BHC supervisor.<sup>27</sup> When the Edge or agreement corporation is held by a U.S. bank, the primary supervisor often relies on information provided by the Federal Reserve in developing its own understanding and assessment of the parent bank.

During each calendar year, the Federal Reserve performs an examination of each Edge and agreement corporation, assesses the Bank Secrecy Act/Anti-Money Laundering

27. The Federal Reserve is solely responsible for approving, and supervising the activities of, U.S. Edge and agreement corporations. As discussed in SR-90-21, "Rating System For International Examinations," one of the Federal Reserve's supervisory responsibilities is the assignment of a CAMEO rating (Capital, Asset Quality, Management, Earnings, and Operations and Internal Controls) to each Edge and agreement corporation.

(BSA/AML) compliance program, and assigns a CAMEO rating. In addition, the Federal Reserve periodically conducts assessments of Edge and agreement corporations to determine whether a consumer compliance examination is warranted, in which case a compliance examination is conducted and a consumer compliance rating is assigned.

The Federal Reserve will coordinate the conduct of its activities as Edge and agreement corporation supervisor with its activities as consolidated supervisor. To this end, the extent and scope of Federal Reserve supervisory work related to an Edge or agreement corporation will be tailored to the entity's activities, risk profile, and other attributes. A number of specific elements will be considered when developing a supervisory approach, including

1. structure and attributes, including whether the Edge or agreement corporation is a banking or investment organization;
2. the size, nature, and location of its primary activities, as well as key financial and other trends;
3. the business lines and risks, and associated trends, of the Edge or agreement corporation's primary activities on a standalone basis, as well as their significance to the risk profile of the parent bank (if applicable) and BHC;
4. the extent to which risk-management and internal control functions are unique to the Edge or agreement corporation, or are shared with a parent bank, another affiliate, or the consolidated BHC;
5. any potential Regulation K limitations or other U.S. compliance issues, and the adequacy of processes to ensure ongoing compliance; and
6. the adequacy of processes for ensuring compliance with all applicable laws and regulations imposed by host-country supervisors for the Edge or agreement corporation's international operations.

*Supervisory Activities:* The Federal Reserve will maintain an understanding and perform an annual examination of each Edge and agreement corporation. While the examination scope will be risk focused to reflect the organization's scale, activities, and risk profile, in all cases the Federal Reserve will assess the adequacy of processes to ensure compliance with BSA/AML requirements and other applicable U.S. laws and regulations and with applicable foreign laws and regulations.

In developing its supervisory strategy, the Federal Reserve will identify those elements that are unique to the Edge or agreement corporation and those that are shared with the parent bank or BHC and will coordinate fulfillment of the Federal Reserve's responsibilities as Edge and agreement corporation supervisor with execution of its consolidated supervision role. This strategy will reflect the extent to which reliance can be placed on (1) the Federal Reserve's understanding and assessments of key corporate governance, risk-management, and control functions, as well as material portfolios and business lines, of the consolidated BHC; (2) assessments developed by the primary supervisor (when applicable) for business lines, risk management, control functions, or financial factors that are common to the Edge or agreement corporation and its parent bank; and (3) findings developed by host-country supervisors for activities under their jurisdiction.

In addition, where the primary supervisor of an Edge or agreement corporation's parent bank relies on the Federal Reserve's understanding and assessment in order to develop its CAMELS rating,<sup>28</sup> the Federal Reserve will work to fulfill that supervisor's information needs.

28. The U.S. banking agencies assign CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) ratings to U.S. banking organizations as part of the ongoing supervision of these organizations. See SR-96-38, "Uniform Financial Institutions Rating System," (see section A.5020.1 of the *Commercial Bank Examination Manual*.) and SR-97-4, "Interagency Guidance on Common Questions About the Application of the Revised CAMELS Rating System."

# Consolidated Supervision of Regional Holding Companies

## Section 1050.2

### 1050.2.1 ACTIVITIES OF THE FEDERAL RESERVE AND OTHER SUPERVISORS AND REGULATORS

The regional banking organization supervisory portfolio generally includes domestic bank holding companies (BHCs) and savings and loan holding companies (SLHCs) having total consolidated assets between \$10 billion and \$100 billion (collectively, “regional holding companies or regional HCs”).<sup>1</sup> Regional HCs include non-traditional holding companies where most or all of the organization’s significant nondepository subsidiaries are regulated by a functional regulator, and subsidiary depository institution(s) are small in relation to nondepository subsidiaries. Regional holding companies are generally subject to the RFI rating system, as described in [SR-19-4/CA-19-3](#), “Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than \$100 billion.”

The primary objective of the Federal Reserve’s consolidated supervision program for firms in the regional banking organization supervisory portfolio is to promote a firm’s safety and soundness and compliance with applicable laws and regulations. The manner in which the Federal Reserve achieves this objective, however, is tailored to the characteristics and risk profiles of regional holding companies.<sup>2</sup>

A range of continuous monitoring activities is utilized, along with testing activities (examination activities),<sup>3</sup> to develop and maintain an understanding and assessment of the condition of a regional HC. For organizations within this portfolio, continuous monitoring activities typically take the form of meetings with the HC’s management, analysis of a firm’s management information system (MIS) reports and regulatory reports, review of surveillance screens, and discussions and coordination with other relevant primary supervisors and functional regulators, including review of their work. Federal Reserve

staff determine the scope and frequency of supervisory monitoring activities based on a firm’s risk profile. For many regional HCs that are in sound condition, examiners perform monitoring activities on a periodic or quarterly basis, supplemented by more frequent or intensive activities as necessary.

#### 1050.2.1.1 Federal Reserve Activities and Those Activities of Other Supervisors and Regulators

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. Many regional HCs conduct the majority of their business operations through a single bank subsidiary, increasing the likelihood that a single primary supervisor has a complete view of, and ability to address, major aspects of the organization’s business activities and related risks, risk management, and controls. In these instances, the Federal Reserve typically will be able to use the information and assessments developed by this primary supervisor of the bank subsidiary to develop an understanding and assessment of the condition of the regional HC and its consolidated activities. However, for a regional HC with more extensive or complex nonbank activities, the Federal Reserve will perform a more extensive assessment of the firm’s risk-management systems and financial condition of nonbank subsidiaries.

By their nature, understanding and assessing some areas—such as the risk management and financial condition of significant nonbank subsidiaries that are not functionally regulated—will require more independent Federal Reserve supervisory work. Other areas—such as primary firmwide risk-management and control functions—will require a greater degree of coordination with other relevant primary supervisors or functional regulators, who will likely have information or assessments upon which the Federal Reserve can draw.

In conducting its supervisory activities for regional HCs, the Federal Reserve will, to the fullest extent possible:

1. The Federal Reserve considers several factors such as a firm’s asset size, complexity of operations, and organizational structure in determining whether a firm is included in the regional banking organization supervisory portfolio or in another supervisory portfolio.

2. See section 1050.0.4, appendix, for definitions of terms commonly used in this section.

3. While by definition “examination” activities are applicable to the supervision of banks and other depository institutions, as well as U.S. banking offices of FBOs, and “inspection” activities are applicable to the supervision of HCs and nonbank subsidiaries and affiliates, the term “examination” is generally used throughout this section to refer to both examination and inspection activities.

- rely on the information, reports, and assessments from relevant primary supervisors and functional regulators, including the reports of examination of such supervisors and regulators; (for more information, see subsection 1050.2.5, “Relying on the Work of Regulators of Subsidiary Insured Depository Institutions”)
- focus its supervisory activities on the holding company, as well as on those of its nonbank subsidiaries that could have a direct or indirect materially adverse effect on the safety and soundness of a depository institution subsidiary of the HC due to the size, condition, or activities of the nonbank subsidiary, or the nature or size of its transactions with the depository institution; and
- use publicly reported information (including externally audited financial statements).

1050.2.1.2 Functionally Regulated Subsidiaries

In certain situations, the Federal Reserve may find it necessary to conduct an examination of a functionally regulated nonbank subsidiary in order to fulfill the Federal Reserve’s responsibilities as supervisor of the consolidated organization. In these cases, the Federal Reserve will follow the procedural and other requirements governing examinations of, or requests for a specialized report from, a functionally regulated subsidiary as discussed in SR-00-13 and sections 1040.0 and 3900.0. For example, the Federal Reserve may conduct an examination of a functionally regulated subsidiary if, after reviewing relevant reports, it determines that the examination is necessary to adequately inform the Federal Reserve about the systems used to monitor and control financial and operational risks within the consolidated organization that may pose a direct or indirect threat to the safety and soundness of a depository institution subsidiary.<sup>4</sup>

4. The Federal Reserve also may examine a functionally regulated subsidiary of a regional HC if, after reviewing relevant reports and other information, examiners have reasonable cause to believe that the subsidiary is engaged in an activity that poses a material risk to an affiliated depository institution, or that the subsidiary is not in compliance with any federal law that the Federal Reserve Board has specific jurisdiction to enforce against the subsidiary (and the Federal Reserve cannot determine compliance by examining the HC or its affiliated depository institutions).

1050.2.2 UNDERSTANDING THE ORGANIZATION

For each regional HC, the Federal Reserve will review information on a firm’s legal, operating, and corporate governance structure, as well as the regional HC’s primary strategies, business lines, and risk-management and internal control functions. Examiners may obtain information from the organization’s management, public reports, regulatory reports, surveillance screens, third-party sources (e.g., credit-rating agency and market analyst reports), and other relevant primary supervisors or functional regulators. Based on the review of this information, examiners develop a risk-assessment and create an appropriately tailored supervisory plan for the HC.

To understand the organizations, examiners generally review the following:

- *Corporate strategy.* Primary business strategies; institutional risk tolerance; key changes in strategic direction or risk profile; significant new business activities; areas of growth and emerging areas with potential to become primary drivers of risk or revenue; and plans for expansion through mergers or acquisitions.
- *Significant activities.* Key revenue and risk drivers; primary business lines; product mix; budget and internal capital allocations (as applicable); market share for revenue and customers served; key external trends, including competitive pressures; and areas that are vulnerable to volatility in revenue, earnings, capital, or liquidity.
- *Structure.* Business line and legal entity structure; domestic and foreign regulatory responsibilities for legal entities and business lines; key interrelationships and dependencies between depository institution subsidiaries and nonbank affiliates; material business lines operated across multiple legal entities for account-

Before requesting a specialized report from a functionally regulated subsidiary, the Federal Reserve should first request the report from the subsidiary’s appropriate functional regulator. In the event that the report is not obtained or made available as requested, the Federal Reserve may, consistent with the Bank Holding Company Act, obtain the report directly from the functionally regulated subsidiary if the report is necessary to allow the Federal Reserve to adequately assess (1) a material risk to the HC or any of its depository institution subsidiaries, (2) the systems used to monitor and control financial and operational risks within the consolidated organization that may pose a threat to the safety and soundness of a depository institution subsidiary, or (3) compliance with any federal law that the Federal Reserve Board has specific jurisdiction to enforce against the BHC or a subsidiary.

ing or risk-management purposes; and the activities and risk profile of Edge and agreement corporation subsidiaries.

- *Corporate governance, risk management, and internal controls for primary risks.* Board of directors (board) and executive-level committees; senior management and management committees; key risk-management and internal control functions and associated MIS relied upon by the board, senior management, and senior risk managers and committees; and consistency of public disclosures that describe the duties and responsibilities of a firm's board and senior management to assess and manage risks.

To improve the quality and consistency of consolidated supervision across the regional HC portfolio, the Federal Reserve compares an individual HC to firms with similar characteristics. Such supervisory activities aid the Federal Reserve in identifying risk-management practices that well-managed organizations employ and evolving practices.

### 1050.2.3 ASSESSING THE REGIONAL HC ON A CONSOLIDATED BASIS

The Federal Reserve uses a systematic approach to develop an assessment of a HC on a consolidated basis. This assessment is reflected in the RFI (Risk Management, Financial Condition, and Impact) rating assigned to a HC.<sup>5</sup>

#### 1050.2.3.1 Risk Management

##### *1050.2.3.1.1 Key Corporate Governance Functions*

*Objectives:* One of the primary areas of focus for consolidated supervision of regional HCs is the adequacy of governance provided by a firm's board and senior management. The culture, expectations, and incentives established by the highest levels of corporate leadership set the tone for the entire organization and are essential determinants of whether a firm can maintain

fully effective risk-management and internal control processes.

The board and its committees should have a process to monitor key inherent risks, associated trends, control functions, and senior management capabilities. Primary expectations for a firm's board or a board committee include:

1. selecting competent senior managers, ensuring that they have the proper incentives to operate the organization in a safe and sound manner, and regularly evaluating senior managers' performance;
2. establishing, communicating, and monitoring (for example, by reviewing comprehensive MIS reports produced by senior management) institutional risk tolerances and a corporate culture that emphasizes the importance of compliance with the law and ethical business practices;
3. approving significant strategies and policies;
4. demonstrating leadership, expertise, and effectiveness;
5. ensuring the organization has an effective and independent internal audit function;
6. ensuring the organization has appropriate policies governing the segregation of duties and avoiding conflicts of interest; and
7. for publicly held organizations, ensuring that public disclosures
  - are consistent with how the board and senior management assess and manage the risks of the organization,
  - balance quantitative and qualitative information with clear discussions about risk-management processes, and
  - reflect evolving disclosure practices for peer organizations.

A regional HC's senior management or a management committee should be able to clearly communicate risk tolerances and measures, control risks, hire and retain competent staff, and respond to changes in the organization's risk profile and the external environment. Members of senior management are expected to have qualifications and experience commensurate with the asset size and complexity of the organization. Primary expectations for senior management include:

1. establishing effective oversight and an appropriate risk culture;
2. appropriately delegating authority and overseeing the establishment and implementation

5. The RFI rating system is discussed in [SR-19-4/CA-19-3](#), "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than \$100 billion." RFI ratings are assigned at least annually for HCs that are complex or that have between \$3 billion and \$100 billion in total consolidated assets, and are communicated via a comprehensive summary supervisory report that supports the HC's assigned ratings and encompasses the results of the entire supervisory cycle. See this manual's section entitled, "Holding Company Ratings Applicability and Inspection Frequency."

- of effective policies for the proper segregation of duties and for the avoidance or management of conflicts of interest;
3. establishing and implementing an effective risk-management framework capable of identifying and controlling both current and emerging risks, and effective independent control functions that ensure risk taking is consistent with the organization’s established risk appetite;
  4. establishing and implementing incentives for personnel that are consistent with institutional risk tolerances, compliance with the law, and ethical business practices;
  5. promoting an effective dialogue between and across business areas and risk-management functions to help align the organization’s established risk appetite and risk controls;
  6. ensuring that the board and its committees are provided with timely, accurate, and comprehensive MIS reports that are adaptive to changing circumstances regarding risks and controls; and
  7. ensuring timely resolution of audit, compliance, and regulatory issues.

An effective internal audit function plays an essential role in providing a firm’s management with an independent and objective evaluation of all key governance, risk-management, and internal control processes. As the complexity of financial products and supporting technology has grown, in combination with greater reliance on third-party service providers, the importance of internal audit’s role in identifying risks and testing internal controls has increased.<sup>6</sup>

In addition, the extent to which supervisors can rely on or utilize the work of internal audit is an essential determinant of the risk-focused supervisory program that is tailored to the activities and risks of individual regional HCs.

*Supervisory Activities:* For each regional HC, the Federal Reserve will review and assess the adequacy of oversight provided by the board and senior management, as well as the adequacy of internal audit and associated MIS. The Federal Reserve also will review and assess other key corporate governance functions (e.g., corporate finance and treasury functions), whose effectiveness is essential to sustaining consolidated holding company operations, as well as the

organization’s business resiliency and crisis management capabilities.<sup>7</sup>

- *Board, senior management, and other key corporate governance functions.* Continuous monitoring activities—which draw from all available sources on an as-needed basis, including internal control functions, the work of other relevant primary supervisors and functional regulators, regulatory reports, and related surveillance results—will be used to understand and assess the effectiveness of board and senior management resources and oversight.<sup>8</sup>

The results of continuous monitoring activities, as documented in supervisory products that reflect the Federal Reserve’s overview and risk assessment of the organization, may identify certain corporate governance functions that will require more intensive supervisory focus due to (1) significant changes in corporate strategy, activities, organizational structure, oversight mechanisms, or key personnel; (2) potential concerns regarding the adequacy of a specific governance function; or (3) the absence of sufficiently recent examination activities for a key function by the Federal Reserve or another primary supervisor or functional regulator.

- *Internal audit.* Continuous monitoring activities will be used to understand and assess key elements of internal audit governance for the consolidated organization, including (1) the adequacy (and, where applicable, independence<sup>9</sup>) of the audit committee; (2) the independence, professional competence, and the quality of the internal audit function; (3) the quality and scope of the audit methodology, audit plan, and risk-assessment process; and (4) the adequacy of audit programs and workpaper standards. On at least an annual basis, the results of these supervisory activities

7. As discussed further in subsection 1050.2.4.6, because of the special structure of nontraditional BHCs and the relatively small size of their depository institution subsidiaries, much of the information necessary to develop the assessments of the risk-management (as described in this subsection 1050.2.3.1) and financial condition elements (as described in subsection 1050.2.3.2) typically may be obtained or drawn from the work of the relevant functional regulator.

8. As noted in subsection 1050.2.1, the scale and frequency of monitoring activities will differ by organization. For many regional HCs in sound condition, these activities are typically performed on a periodic or quarterly basis and supplemented as necessary.

9. As outlined in section 2060.05, “The Sarbanes-Oxley Act of 2002,” section 301 of the Sarbanes-Oxley Act requires that each public company (including banks, bank holding companies, and savings and loan holding companies that are public companies) have an audit committee composed entirely of independent directors. (See 15 U.S.C. 78j-1.)

6. SR-13-1/CA-13-1, “Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing.”

will be reviewed to determine whether there have been significant changes in the internal audit infrastructure or whether there are potential concerns regarding the adequacy of key elements of internal audit. In addition to this periodic audit infrastructure review, testing activities for specific control functions or business lines should include an assessment of internal audit's recent work in these areas to the extent possible as a means of validating internal audit's findings.

- *Additional supervisory activities.* If continuous monitoring activities identify a key corporate governance function or element of internal audit requiring more intensive supervisory focus due to significant changes, potential concerns, or the absence of sufficiently recent examination activities, the Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) in developing target reviews or testing activities focusing on the area of concern. In situations where another primary supervisor or functional regulator leads the examination activities, the Federal Reserve may conduct portions of the examination, or otherwise participate as necessary (e.g., in determining the examination objectives and scope), to ensure that the review provides sufficient information on the specific area of concern to form a comprehensive and timely understanding and assessment.

If the area of concern is not within the oversight of another primary supervisor or functional regulator, or if the supervisor or regulator does not conduct or coordinate the examination activities in a reasonable period of time, the Federal Reserve will lead the necessary examination activities in coordination with other relevant primary supervisors and functional regulators to the extent possible.

- *Additional required audit testing activities.* In all instances, the Federal Reserve will conduct testing activities as part of its audit infrastructure review (either by leading the activities and coordinating with other relevant primary supervisors or functional regulators, or participating in activities led by other relevant supervisors or regulators) on at least a three-year cycle to ensure that the internal audit program is appropriately designed and achieving its objectives.<sup>10</sup>

10. For nontraditional HCs, the Federal Reserve will routinely conduct testing activities on at least a three-year cycle in instances where the HC's relevant functional regulator has not developed—or, because of the organization's legal, oper-

In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described in subsection 1050.2.1.2.

### *1050.2.3.1.2 Risk-Management and Internal Control Functions for Primary Risks to the Consolidated Organization*

*Objectives:* A firm is responsible for developing and maintaining an appropriate control structure for identifying, measuring, monitoring, and controlling key risks and complying with applicable statutes and regulations. Further, a firm's risk-management and internal control functions should promote the firm's safety and soundness.

As part of supervisory activities for a regional HC, the Federal Reserve will review and assess risk-management and control functions for primary risks to the consolidated organization (primary firmwide risk-management and control functions), and associated MIS. This review includes an assessment of the risk-management and control functions for primary credit, legal and compliance, liquidity, market, operational, and reputational risks for the consolidated organization.<sup>11</sup> The Federal Reserve also will review and assess other risk-management and control functions that, based on the specific characteristics and activities of the individual HC, relate to primary risks to the organization as a whole.

For example, for regional HCs with particularly dynamic corporate strategies, the Federal Reserve will review and assess the adequacy of the control mechanisms relevant to such strategies, including strategic planning, merger integration, new business approval, and processes to confirm that risk management and controls are keeping pace with areas of growing inherent risk.

In all instances, the adequacy of each primary firmwide risk management or control mechanism depends on the appropriateness of the following:

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ating, and regulatory structure, is not able to develop—a comprehensive understanding and assessment of the internal audit infrastructure.

11. Federal Reserve processes for reviewing and assessing legal and compliance risk management also encompass consumer compliance risk inherent in the organization's business activities. See SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$100 Billion."

1. control infrastructure and governance, including degree of oversight by the board and senior management;
2. development, maintenance, and communication of appropriate policies, procedures, and internal controls;
3. risk identification and measurement systems and processes, and associated MIS, that are adaptive to changing circumstances and capable of providing timely, accurate, and comprehensive information to senior management and the board;
4. monitoring and testing the effectiveness of controls;
5. processes for identifying, reporting, and escalating issues and emerging risks;
6. ability to implement corrective actions in a timely manner;
7. appropriate authority and independence of staff to carry out responsibilities; and
8. integration of risk-management and control objectives within management goals and the organization's compensation structure.

Firms in the regional supervisory portfolio use a variety of control structures to monitor, manage, and control firmwide risks. A number of larger firms have implemented firmwide risk-management functions to measure and assess the range of a firm's exposures across business lines and legal entities and the way these exposures interrelate. However, some regional HCs effectively control risks using a decentralized approach that relies on individual control structures for the organization's primary business lines or legal entities. In all instances, the Federal Reserve will assess whether a firm's key control function is effective in controlling primary risks to the consolidated organization.

*Supervisory Activities:* The Federal Reserve will use continuous monitoring activities to review and assess each primary firmwide risk-management and control function. This process begins with the overarching design and architecture of each primary firmwide risk-management or control function, and drills down, as appropriate, through analysis of risk management and controls for material portfolio areas and business lines (described in subsection 1050.2.3.1.3). Federal Reserve staff will verify the sufficiency of fundamental aspects of internal controls in relation to the holding company's current risk profile. In particular, supervisory activities focus on assessing the adequacy

of a firm's primary control functions and whether a firm's control functions (centralized or decentralized) remain effective in the face of growth, changing strategic direction, significant market developments, and other internal or external factors.

The results of continuous supervisory monitoring activities may identify certain primary firmwide risk-management or control functions that require more intensive supervisory focus due to (1) significant changes in inherent risk, control processes, or key personnel; (2) potential concerns regarding the adequacy of controls; or (3) the absence of sufficiently recent examination activities for a primary firmwide risk-management or control function by the Federal Reserve or another relevant primary supervisor or functional regulator.

The Federal Reserve will work with other relevant primary supervisors or functional regulators (where applicable) to develop reviews or testing activities focusing on the area of concern. In situations where another primary supervisor or functional regulator leads the examination activities, the Federal Reserve may conduct portions of the examination, or otherwise participate as necessary (e.g., in determining the examination objectives and scope), to ensure that the review provides sufficient information on the specific area of concern to form a comprehensive and timely understanding and assessment.

If the firmwide risk-management or control function is not within the oversight of another primary supervisor or functional regulator, or if the primary supervisor or functional regulator does not conduct or coordinate the examination activities in a reasonable period of time, the Federal Reserve will lead the necessary examination activities in coordination with other relevant supervisors and regulators to the extent possible. For a firm with functionally regulated subsidiaries, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described in subsection 1050.2.1.2.

1050.2.3.1.3 Risk Management of Material Portfolios and Business Lines

*Objectives:* For each regional HC, there are selected portfolio risk areas (such as retail or wholesale credit risk) or individual business lines (such as residential mortgage or commercial real estate lending) that are primary drivers of risk or revenue, or that otherwise materially contribute to either understanding

inherent risk within the consolidated organization or assessing controls for a broader corporate function (such as consolidated credit-risk management).

As part of the overview and risk assessment of a firm, the Federal Reserve will analyze external factors and internal trends in the HC's strategic initiatives—as evidenced by budget and (where applicable) internal capital allocations and other factors—to identify significant activities and areas vulnerable to volatility in revenue, earnings, capital, or liquidity that represent material risks or activities of the organization. This determination of material portfolios and business lines considers all associated risk elements, including legal and compliance risks. For example, when evaluating whether retail activities such as mortgage or automobile lending are material to a banking organization, the extent of inherent consumer compliance and reputational risks, as well as interest rate and credit risks, should be considered.

*Supervisory Activities:* Because an understanding of material risks and activities is needed to assess the primary firmwide risk-management and control functions (as discussed in preceding subsection 1050.2.3.1.2), the Federal Reserve will maintain an understanding of inherent risk and assess the adequacy of risk management and internal controls for material portfolios and business lines. To form this understanding and assessment, the Federal Reserve will rely primarily on continuous monitoring activities, supplemented, as appropriate, by examination activities.

To the fullest extent possible, the Federal Reserve will base its review and assessment of these risks and risk-management practices from the information and assessment of the primary supervisor or functional regulator where the HC's legal and operating structure provides the supervisor or regulator a sufficient view of these areas. In these instances, the Federal Reserve will undertake continuous monitoring and participate in activities led by primary supervisors and functional regulators, as necessary, to maintain an understanding and assessment of related firmwide risk-management and control functions.

A regional HC's activities may span legal entities that are subject to oversight by multiple supervisors or regulators or that are outside the oversight of other supervisors or regulators. In these cases, or if the primary supervisor or functional regulator does not conduct or coordinate the necessary continuous monitoring or examination activities in a reasonable period of

time, the Federal Reserve will initiate and lead these activities in coordination with other relevant primary supervisors and functional regulators to the extent possible. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its supervisory and testing activities in accordance with the provisions described in subsection 1050.2.1.2.

#### 1050.2.3.1.4 Risk Management of Nonmaterial Business Lines

*Objectives:* For nonmaterial business lines identified during the development of the scope of supervisory activities, the Federal Reserve will focus on identifying and reviewing those business lines that are increasing in importance to a firm's operations and have the potential to become a material risk to the firm.

*Supervisory Activities:* When a primary supervisor or functional regulator has a sufficient view of nonmaterial business lines, the Federal Reserve will, to the fullest extent possible, use information developed by that supervisor or regulator to monitor areas of increasing importance with the potential to become a material risk. The Federal Reserve also will maintain access internal MIS for these businesses to facilitate a more in-depth analysis of a business line, if appropriate, to understand its growing importance to the organization.

For nonmaterial business lines that are not subject to oversight by a single primary supervisor or functional regulator, the Federal Reserve will engage in continuous monitoring activities to identify meaningful trends in risks and risk-management practices. Further, the Federal Reserve will assess the adequacy of associated MIS for the business line, if appropriate, to determine its importance to the organization.

#### 1050.2.3.2 Financial Condition

*Objectives:* The Federal Reserve's evaluation of a regional HC's consolidated financial condition focuses on the ability of the organization's resources to support the level of risk associated with its activities. Assessments are developed for each "CAEL" subcomponent: Capital Adequacy (C), Asset Quality (A), Earnings (E),

and Liquidity (L).<sup>12</sup> In developing this evaluation, the Federal Reserve’s primary focus is on reviewing and assessing:

- 1. the sufficiency of the HC’s consolidated capital to support the level of risk associated with the organization’s activities and provide a sufficient cushion to absorb unanticipated losses;
- 2. the capability of liquidity levels and funds-management practices to allow reliable access to sufficient funds to meet present and future liquidity needs; and
- 3. other aspects of financial strength that need to be assessed on a consolidated basis across the organization’s various legal entities, or that relate to the financial soundness of the parent company and significant nonbank subsidiaries, as discussed in subsection 1050.2.3.3.

In assessing consolidated regulatory capital, the Federal Reserve determines whether the HC has an effective framework for complying with relevant capital regulations.<sup>13</sup> This assessment utilizes results from examinations led by the Federal Reserve or other primary supervisors or functional regulators, as well as information gained from the HC’s internal control functions and from market-based assessments, where available.

When assessing the adequacy of a HC’s liquidity levels and funds-management practices, examiners focus on<sup>14</sup>

- 1. the extent to which the treasury function is aligned with risk-management processes, and whether incentives are in place for business lines to compile and provide information on expected liquidity needs and contingency funding plans so that the treasury function is able to develop a firmwide perspective and incorporate business line information into assessments of actual and contingent liquidity risk;
- 2. whether funds-management practices provide sufficient funding flexibility to respond to unanticipated, evolving, and potentially

correlated market conditions for the organization and/or across financial markets; and

- 3. the sufficiency of liquidity planning tools, such as stress testing, scenario analysis, and contingency planning efforts, including (1) whether liquidity buffers—comprised of unencumbered liquid assets as well as access to stable funding sources—adequately reflect the possibility and duration of severe liquidity shocks; (2) the reasonableness of assumptions about the stability of secured funding in circumstances in which the liquidity of markets for the underlying collateral becomes impaired; and (3) whether these efforts adequately reflect the potential for the organization to be called on in stressed environments to provide contingent liquidity support to off-balance-sheet entities or bring additional assets on the balance sheet (even if not legally or contractually obligated to do so).

Beyond capital adequacy and liquidity, Federal Reserve supervisory staff evaluate a regional HC’s consolidated financial condition considering the availability of information or assessments from other relevant primary supervisors or functional regulators. For example, Federal Reserve staff may perform additional work to assess consolidated asset quality or earnings for regional HCs with significant nonbank activities that are not functionally regulated. However, where all material holding company assets are concentrated in a single depository institution subsidiary, Federal Reserve will perform a minimal level of incremental review and analysis to assess the firm’s consolidated asset quality and earnings.

*Supervisory Activities:* The Federal Reserve will primarily utilize continuous monitoring activities to assess a regional HC’s financial strength. Such activities will include periodic meetings with the HC’s management (such as the chief financial officer); review of regulatory reports, surveillance screens, and internal MIS; and analysis of market indicators (where available), including external debt ratings, subordinated debt spreads, and credit default swap spreads. Testing and discovery activities will be used as necessary to assist in reviewing and assessing areas of concern.

Testing activities are used to assess the sufficiency of the HC’s consolidated capital and liquidity positions to support the level of risk associated with a firm’s activities, including (1) regulatory capital calculation methodologies and, where applicable, internal assessments of

12. See [SR-19-4/CA-19-3](#) for more information about the CAEL subcomponents.

13. See for example Regulation Q (12 CFR part 217).

14. Assessing liquidity levels and funding practices for a consolidated BHC also incorporates elements presented in subsection 1050.2.3.3.2 on “Parent Company and Nonbank Funding and Liquidity.”

capital adequacy<sup>15</sup> and (2) funds-management and liquidity planning tools and practices. The Federal Reserve will work with other primary supervisors and functional regulators to participate in or, if necessary, to coordinate activities designed to analyze key capital and liquidity models or processes of a depository institution or functionally regulated subsidiary, which based on the significance of the activity, would influence the Federal Reserve's supervisory assessment. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described in subsection 1050.2.1.2.

### 1050.2.3.3 Impact

#### *1050.2.3.3.1 Risk Management and Financial Condition of Significant Nonbank Subsidiaries*

**Objectives:** Many regional HCs engage in activities and manage control functions on a firmwide basis, spanning depository institution and nonbank legal entities. In some instances, these HCs have intra-group exposures and servicing arrangements across affiliates, presenting increased potential risks for depository institution subsidiaries and a higher likelihood of aggregate risk concentrations across the organization's legal entities. Common interactions between a regional HC's depository institution subsidiaries and their nonbank affiliates (including the parent company) include assets originating in, or being marketed by, a nonbank affiliate that are booked in the depository institution; a depository institution providing funding for nonbank affiliates; and risk-management or internal control functions being shared between depository and nonbank operations.

Due to these interrelationships, financial, legal, compliance, or reputational risks in one part of a HC can affect other parts of the organization. Even absent these interactions, the parent or nonbank subsidiaries of an organization may present financial, legal, compliance, or reputational risk to the consolidated entity, and thus to

its depository institution subsidiaries. As the consolidated supervisor, the Federal Reserve is responsible for reviewing and assessing the risks that the parent holding company and its nonbank subsidiaries may pose to the holding company or its depository institution subsidiaries. The primary objectives of Federal Reserve supervision of the nonbank subsidiaries of a holding company are to:

1. identify significant nonbank activities and risks—where the parent company or nonbank subsidiaries engage in risk-taking activities or hold exposures that are material to the risk management or financial condition of the consolidated organization or a depository institution subsidiary—by developing an understanding of the size and nature of primary activities and key trends, and the extent to which business lines, risks, or control functions are shared with or may impact a depository institution affiliate;
2. evaluate the financial condition and the adequacy of risk-management practices of the parent and significant nonbank subsidiaries, including the ability of nonbank subsidiaries to repay advances provided by the parent, using benchmarks and analysis appropriate for those businesses;
3. evaluate the degree to which nonbank entity risks may present a threat to the safety and soundness of subsidiary depository institutions, including through transmission of legal, compliance, or reputational risks;
4. identify and assess any intercompany relationships, dependencies, or exposures—or aggregate firmwide concentrations—with the potential to threaten the condition of a depository institution affiliate; and
5. evaluate the effectiveness of the policies, procedures, and systems that the holding company and its nonbank subsidiaries use to ensure compliance with applicable statutes and regulations, including consumer protection laws.

**Supervisory Activities:** For all significant nonbank subsidiaries and activities of the parent HC, the Federal Reserve will use continuous monitoring activities to:

1. maintain an understanding of the holding company's business line and legal entity structure, including key interrelationships and dependencies between depository institution

15. Capital planning activities for all HCs should be forward looking and provide for a sufficient range of stress scenarios commensurate with the organization's risk tolerance and activities. For those regional HCs that utilize more-rigorous and structured internal processes for assessing capital adequacy beyond regulatory capital measures, the Federal Reserve focuses on whether such internal processes confirm that all risks are properly identified, reliably quantified (where possible) across the entire organization, and supported by adequate capital.

- subsidiaries and nonbank affiliates, utilizing regulatory structure reports, internal MIS, and other information sources;
2. understand and assess the exposure to, and tolerance for, legal, compliance, and reputational risks, as well as the extent to which potential conflicts of interest are identified and avoided or managed;
  3. understand the scope of intercompany transactions and aggregate concentrations, and assess the adequacy of risk-management processes, accounting policies, and operating procedures to measure and manage related risks;
  4. identify and assess key interrelationships and dependencies between subsidiary depository institutions and nonbank affiliates, such as the extent to which a depository institution subsidiary is reliant on services provided by the parent company or other nonbank affiliates and the reasonableness of associated management fees;
  5. identify those nonbank subsidiaries whose activities present material financial, legal, compliance, or reputational risk to the consolidated entity and/or a depository institution subsidiary;
  6. identify significant businesses operated across multiple legal entities for accounting, risk management, or other purposes, as well as activities that functionally operate as separate business units for legal or other reasons;
  7. identify intercompany transactions subject to Regulation W—utilizing information submitted on quarterly regulatory reporting form FR Y-8 (“The Holding Company Report of Insured Depository Institutions’ Section 23A Transactions with Affiliates”), internal MIS, and other information sources—and determine (in conjunction with the primary supervisor) whether compliance issues are present; and
  8. understand and assess the sufficiency, reliability, and timeliness of associated MIS relied upon by the board, senior management, and senior risk managers and committees to monitor key activities and risks.

Federal Reserve staff may use periodic testing to supplement continuous monitoring to (1) ensure that key risk-management and internal control practices conform to internal policies and/or are designed to ensure compliance with the law, and (2) understand and assess operations presenting a moderate or greater like-

lihood of significant negative impact to a subsidiary depository institution or the consolidated organization. Areas of potential negative impact include financial or operational risks that pose a potential threat to the safety and soundness of a depository institution subsidiary, or to the holding company’s ability to serve as a source of financial and managerial strength to its depository institution subsidiaries. Testing will focus on controls for identifying, monitoring, and controlling such risks. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described in subsection 1050.2.1.2.

1050.2.3.3.2 *Parent Company and Nonbank Funding and Liquidity*

*Objectives:* One of the Federal Reserve’s primary responsibilities as consolidated supervisor is to help ensure that the parent company and its nonbank subsidiaries do not have an adverse impact on the organization’s depository institution subsidiaries. To meet this objective, the Federal Reserve will assess the extent to which funding and liquidity policies and practices of the parent company or nonbank subsidiaries may undermine the HC’s ability to act as a source of strength to the organization’s depository institution subsidiaries.

Areas of focus will include an assessment of:

1. the ability of the parent company and nonbank subsidiaries to maintain sufficient liquidity, cash flow, and capital strength to service their debt obligations and cover fixed charges;
2. the likelihood that parent company or nonbank funding strategies could undermine public confidence in the liquidity or stability of subsidiary depository institution(s);
3. policies and practices that are aimed at ensuring the stability of parent company funding and liquidity, as evidenced by the utilization of long-term or permanent financing to support capital investments in subsidiaries and other long-term assets, and the degree of dependence on short-term funding mechanisms such as commercial paper;
4. the extent of “double leverage”<sup>16</sup> and the organization’s capital management policies, including the distribution and transferability of capital across jurisdictions and legal entities; and

16. “Double leverage” refers to situations in which debt is issued by the parent company and the proceeds are invested in subsidiaries as equity.

5. the parent company's ability to provide financial and managerial support to its depository institution subsidiaries during periods of financial stress or adversity, including the sufficiency of related stress testing, scenario analysis, and contingency planning efforts.

The Federal Reserve also will monitor a firm's funding profile—including intraday liquidity management policies and practices<sup>17</sup>—and market access of material depository institution subsidiaries, as in most instances these entities represent the consolidated HC's primary and most active vehicles for external funding and liquidity management. The primary supervisor retains responsibility for assessing liquidity risk-management practices with respect to the depository institution subsidiary.

*Supervisory Activities:* Supervisory Activities: The Federal Reserve will use continuous monitoring activities—including monitoring market conditions and indicators where available—and target examinations to review and assess parent company's and nonbank subsidiary's funding and liquidity policies and practices, as well as any potential negative impact these policies and practices might have on a subsidiary depository institution or the consolidated organization. On an annual basis, Federal Reserve staff will review a firm's funding and liquidity policies and practices to determine whether there have been (1) a significant change in inherent funding or liquidity risk stemming from changing strategies or activities; or (2) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk-management or internal controls; as well as whether examiners have any potential concern regarding the adequacy of related risk-management or internal controls.

If significant changes or potential concerns are identified, the Federal Reserve will design and conduct testing activities focused on reviewing and assessing the areas of change and/or concern in order to confirm that funding and liquidity risk-management and control functions are appropriately designed and achieving their intended objectives.

For regional HCs where parent company or nonbank subsidiary third-party debt obligations are deemed to be material in relation to equity or may otherwise have a potentially negative impact on the HC's ability to serve as a source of strength for its depository institution subsidi-

aries, the Federal Reserve will undertake testing activities on at least a three-year cycle, assessing the individual elements of risk management for parent company and nonbank funding and liquidity: board and senior management oversight; policies, procedures, and limits; risk monitoring and management information systems; and related internal controls. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described in subsection 1050.2.1.2.

## 1050.2.4 INTERAGENCY COORDINATION

### 1050.2.4.1 Coordination and Information Sharing Among Domestic Primary Bank Supervisors and Functional Regulators

*Objectives:* Effective consolidated supervision requires strong, cooperative relationships between the Federal Reserve and other relevant domestic primary bank supervisors and functional regulators.<sup>18</sup> To achieve this objective, the Federal Reserve has worked over the years to enhance interagency coordination through the development and use of information-sharing protocols and mechanisms. These protocols and mechanisms respect the individual statutory authorities and responsibilities of the respective supervisors and regulators, provide for appropriate information flows and coordination to limit unnecessary duplication or burden, comply with restrictions governing access to information, and ensure that the confidentiality of information is maintained.

As discussed in subsection 1050.2.3, reviewing and assessing the activities and risks of the organization as a whole, the Federal Reserve will rely to the fullest extent possible on the examination and other supervisory work conducted by the domestic primary bank supervisors and functional regulators of a HC's subsidiaries. In addition, the Federal Reserve will seek to coordinate its supervisory activities with relevant supervisors and regulators, and will work to align each agency's assessment of key corporate governance functions, risk-management and internal control functions for primary risks, financial condition, and other areas of the consolidated HC's operations as applicable.

18. Subsection 1050.2.4.2 discusses cooperation and information sharing among foreign supervisors.

17. More information on payment systems risk is available on the Board's public website.

*Supervisory Activities:* The Federal Reserve will continue to work with the relevant primary supervisors and functional regulators of a regional HC’s subsidiaries to ensure that the necessary information flows and coordination mechanisms exist to permit the effective supervision of the HC on a consolidated basis. The Federal Reserve will continue to share information, including confidential supervisory information, obtained or developed through its consolidated supervisory activities with other relevant primary supervisors or functional regulators when appropriate and permitted by applicable statutes and regulations.<sup>19</sup>

The Federal Reserve also will continue to use a variety of formal and informal channels to facilitate interagency information sharing and coordination consistent with the principles outlined above, including

- supervisory protocols, agreements, and memoranda of understanding (MOUs) with primary supervisors and functional regulators that allow the coordination of supervisory activities and that permit the ongoing exchange of information, including confidential information on a confidential basis;
- bilateral exchanges of letters to facilitate information sharing on a situation-specific basis;
- periodic and as-needed contacts with primary supervisors and functional regulators to discuss and coordinate matters of common interest, including the planning and conduct of examinations and continuous monitoring activities;
- the use of information technology platforms to provide secure automated access to examination/inspection reports and other supervisory information prepared by the Federal Reserve and other relevant supervisors and regulators; and
- participation in a variety of interagency forums that facilitate the discussion of broad industry issues and supervisory strategies, including the Federal Financial Institutions Examination Council, the President’s Working Group on Financial Markets, and the Fed-

eral Reserve-sponsored cross-sector meetings of financial supervisors and regulators.

*1050.2.4.1.1 Coordination of Examination Activities at a Supervised HC Subsidiary*

The Federal Reserve will seek to work cooperatively with the relevant primary supervisor or functional regulator to address information gaps or indications of weakness or risk identified in a supervised HC subsidiary that are material to the Federal Reserve’s review or assessment of the consolidated organization’s risks, activities, or key corporate governance, risk-management, or control functions. Prior to conducting testing activities at a depository institution (other than where the Federal Reserve is the primary federal supervisor) or functionally regulated subsidiary of a HC, the Federal Reserve will:

- review available information sources as part of its continuous monitoring activities, including examination reports and the HC’s internal MIS, to determine whether such information addresses the Federal Reserve’s information needs or supervisory concerns; and
- if needed, seek to gain a better understanding of the primary supervisor’s or functional regulator’s basis for its supervisory activities and assessment of the subsidiary. This may include a request to review related examination work.

If, following these activities, the Federal Reserve’s information needs or supervisory concerns remain, the Federal Reserve will work cooperatively with the relevant primary supervisor or functional regulator in the manner discussed in subsection [1050.2.3](#).<sup>20</sup>

*1050.2.4.2 Cooperation and Information Sharing With Host-Country Foreign Supervisors*

*Objectives:* Some regional HCs have international banking and other operations that are licensed and supervised by foreign host-country authorities. As home-country supervisor for domestic HCs, the Federal Reserve is responsible for the comprehensive, consolidated super-

19. Among the federal laws that may limit the sharing of information among supervisors are the Right to Financial Privacy Act (12 U.S.C. 3401 *et seq.*) and the Trade Secrets Act (18 U.S.C. 1905). The Federal Reserve has established procedures to authorize the sharing of confidential supervisory information, and Federal Reserve staff must ensure that appropriate approvals are obtained prior to releasing such information. See Subpart C of the Board’s Rules Regarding the Availability of Information (12 CFR 261.20 *et seq.*).

20. As outlined in subsection [1050.2.3](#), certain Federal Reserve examination activities are to be conducted on a minimum three-year cycle to verify, through testing, the sufficiency of key control processes. These activities are to be conducted regardless of whether or not there is an information gap or indication of weakness or risk.

vision of these organizations, while each host country is responsible for supervision of the legal entities (including foreign subsidiaries of U.S. HCs) in its jurisdiction.

Information sharing among domestic and foreign supervisors, consistent with applicable laws, is essential to ensure that a regional HC's global activities are supervised on a consolidated basis. Cross-border information sharing is often facilitated by an MOU that establishes a framework for bilateral relationships and includes provisions for cooperation during the licensing process, in the supervision of ongoing activities, and in the handling of problem institutions. The Federal Reserve has established bilateral and multilateral information-sharing MOUs and other arrangements with numerous host-country foreign supervisors. The Federal Reserve also monitors changes in foreign bank regulatory and supervisory systems and seeks to understand how these systems affect supervised banking organizations. In addition to its longstanding cooperative relationships with home- and host-country foreign supervisors, the Federal Reserve expects to increasingly lead and participate in supervisory colleges and other multilateral groups of supervisors that discuss issues related to specific, internationally active banking organizations.

The Federal Reserve's processes for reviewing and assessing firmwide legal and compliance risk management, as described earlier, encompass both domestic and international operations. Most areas of supervisory focus for a firm's management of legal and compliance risks are applicable to both domestic and international entities, and include proper oversight of licensed operations, compliance with supervisory and regulatory requirements, and the sufficiency of associated MIS.

There are, however, areas of focus for the Federal Reserve that are unique to a holding company's international operations. For example, some host-country legal and regulatory structures and supervisory approaches are fundamentally different from those in the United States. As a result, the banking organization often must devote additional resources to maintain expertise in local regulatory requirements. In some instances, privacy concerns have led to limits on the information a HC's foreign office may share with its parent company, thereby limiting the parent company's ability to exercise consolidated risk management on a global basis.

Additionally, the Federal Reserve and other U.S. supervisors have at times faced challenges in accessing information on a bank's or HC's

foreign operations or in carrying out examinations of cross-border or foreign activities. These circumstances are to be taken into account when developing a supervisory strategy for a regional HC with cross-border or foreign operations.

*Supervisory Activities:* For regional HCs with international operations, Federal Reserve's continuous monitoring will be used to review and assess each HC's international strategy, trends, operations, and legal entity structure, as well as related governance, risk management, and internal controls. For a regional HC with significant international operations or risks, an assessment of cross-border and foreign operations will be incorporated into the evaluation of key corporate governance functions and primary firmwide risk-management and internal control functions, including legal and regulatory risk management.

Continuous monitoring activities will include reviewing materials prepared by host-country supervisors, including examination reports and assessments, and ongoing communication with relevant foreign and domestic supervisors regarding trends and assessments of cross-border and foreign operations.

When assessing the sufficiency of a regional HC's management of its international operations, Federal Reserve staff will consider the extent to which foreign laws restrict the transmission of information to the HC's head office. Impediments to sharing information imposed by a host country may constrain the HC's ability to effectively oversee its international operations and globally manage its risks, and the materiality of such impediments should be a determinant of whether the organization should be conducting operations in that host country.

In addition, any limits placed on the Federal Reserve's ability to access information on host-country operations, or to engage in supervisory activities at the organization's operations in the host country, should be considered when assessing whether the organization's activities in that jurisdiction are appropriate.

#### 1050.2.4.3 Indications of Weakness or Risk Related to Subsidiary Depository Institutions

*Objectives:* For areas beyond those specifically addressed in subsection 1050.2.3, there may be circumstances where the Federal Reserve has

indications of material weakness or risk in a depository institution subsidiary of a HC that is supervised by another primary supervisor, and it is not clear that the weakness or risk is adequately reflected in the assessment or supervisory activities of that supervisor. Because a primary objective of consolidated supervision is to protect the HC's depository institution subsidiaries, the Federal Reserve will follow up with the appropriate primary supervisor in these circumstances to help ensure that, to the extent that a material weakness or risk exists, these weaknesses are addressed appropriately by the HC and its depository institution subsidiaries.

*Supervisory Activities:* The Federal Reserve will take the following steps when there are indications of material weakness or risk in a depository institution subsidiary (other than where the Federal Reserve is the primary federal supervisor) in an area beyond those specifically addressed in subsection 1050.2.3. Further, the Federal Reserve will take these steps when it is not clear whether the depository institution's primary supervisor has reflected the weakness or risk in its assessment.

- The Federal Reserve will first review available information sources, discuss the areas of concern with the primary supervisor, and seek to review the supervisor's related work.
- If concerns remain following these activities, the Federal Reserve will request that the primary supervisor conduct a review or testing activity at the depository institution to address the area of concern.
- In the event the primary supervisor does not undertake activities to address the concern in a reasonable period of time, the Federal Reserve will design and lead an examination of the depository institution to address the matter in consultation with the primary supervisor. A senior Federal Reserve official will communicate this decision in writing to a senior official of the primary supervisor.

1050.2.4.4 Condition or Management of HC Subsidiary is Less than Satisfactory

*Objectives:* As noted above, a primary responsibility of the Federal Reserve as consolidated HC supervisor is to confirm that a holding company's activities, policies, and practices do not undermine its ability to serve as a source of

financial and managerial strength to its depository institution subsidiaries. In situations where the condition or management of a supervised or functionally regulated HC subsidiary is determined to be less than satisfactory, the Federal Reserve's focus as consolidated supervisor is on complementing the efforts of the primary supervisor or functional regulator. In doing so, the Federal Reserve will seek to confirm that the parent company provides appropriate support to the subsidiary and does not take actions that may further weaken the parent company's depository institution subsidiaries or its ability to act as a source of strength for such subsidiaries.

Beyond the specific activities noted below, these circumstances also may require the Federal Reserve to enhance the activities addressed in subsection 1050.2.3 for reviewing and assessing key corporate governance functions, or primary firmwide risk management and internal controls. In addition, the Federal Reserve will adjust its supervisory activities as necessary when the consolidated HC is in weakened condition or when there are questions regarding the capabilities of the holding company's management.

*Supervisory Activities:*

- *Depository institution subsidiary.* In instances when a depository institution subsidiary's condition or management is rated less than satisfactory, or when the depository institution subsidiary otherwise faces financial stress or material risks, the Federal Reserve's primary supervisory objectives as consolidated supervisor are to confirm that the parent company (1) provides appropriate support to the depository institution, and (2) does not take action that could harm the depository institution. The Federal Reserve will work closely with the primary supervisor to assess whether the HC or a nonbank affiliate has contributed to the depository institution's weakened condition, to evaluate the impact of the depository institution on the HC's financial condition, and to determine if the holding company is providing appropriate support to the depository institution.
- *Nonbank subsidiary.* When any nonbank subsidiary faces financial stress or material risks, the Federal Reserve will seek to assess that its condition and activities do not jeopardize the safety and soundness of the HC or its depository institution subsidiaries, as discussed in subsections 1050.2.3.3.1, "Risk Management and Financial Condition of Significant Nonbank Subsidiaries" and 1050.2.3.3.2, "Parent

Company and Nonbank Funding and Liquidity.” The Federal Reserve also will take appropriate steps to confirm that any actions taken by the parent company to assist a nonbank subsidiary do not impair the HC’s continuing ability to serve as a source of strength to its depository institution subsidiaries. The Federal Reserve will coordinate its activities with those of any relevant functional regulator to the extent appropriate.

#### 1050.2.4.5 Edge and Agreement Corporations

*Objectives:* Some regional HCs control an Edge or agreement corporation subsidiary. The Federal Reserve serves as the primary supervisor of each Edge and agreement corporation subsidiary in addition to its role as consolidated holding company supervisor.<sup>21</sup> When the Edge or agreement corporation is a subsidiary of a U.S. bank, the primary supervisor often relies on information provided by the Federal Reserve in developing its own understanding and assessment of the parent bank.

During each calendar year, the Federal Reserve performs an examination of each Edge and agreement corporation, assesses the Bank Secrecy Act/Anti-Money-Laundering (BSA/AML) compliance program, and assigns a CAMEO rating. In addition, the Federal Reserve periodically conducts assessments of Edge and agreement corporations to determine whether a consumer compliance examination is warranted, in which case a compliance examination is conducted and a consumer compliance rating is assigned.

The Federal Reserve will coordinate the conduct of its activities as Edge and agreement corporation supervisor with its activities as consolidated supervisor. To this end, the extent and scope of Federal Reserve supervisory work related to an Edge or agreement corporation will be tailored to the entity’s activities, risk profile, and other attributes. A number of specific elements will be considered when developing a supervisory approach, including:

1. structure and attributes, including whether the Edge or agreement corporation is a banking or investment organization;
2. the size, nature, and location of its primary activities, as well as key financial and other trends;
3. the business lines and risks, and associated trends, of the Edge or agreement corporation’s primary activities on a standalone basis, as well as their significance to the risk profile of the parent bank (if applicable) and HC;
4. the extent to which risk-management and internal control functions are unique to the Edge or agreement corporation, or are shared with a parent bank, another affiliate, or the consolidated HC;
5. any potential Regulation K limitations or other U.S. compliance issues, and the adequacy of processes to ensure ongoing compliance; and
6. the adequacy of processes for ensuring compliance with all applicable statutes and regulations imposed by host-country supervisors for the Edge or agreement corporation’s international operations.

*Supervisory Activities:* The Federal Reserve will perform an annual examination for each Edge and agreement corporation. While the examination scope will be tailored to reflect the organization’s size, activities, and risk profile, in all cases the Federal Reserve will assess the adequacy of processes to ensure compliance with BSA/AML requirements and other applicable U.S. statutes and regulations, and with applicable foreign statutes and regulations.

In developing its supervisory strategy, the Federal Reserve will identify those risks and activities that are unique to the Edge or agreement corporation and those that are shared with the parent bank or HC, and will coordinate fulfillment of the Federal Reserve’s responsibilities as Edge and agreement corporation supervisor with execution of its consolidated supervision role.

This strategy will reflect the extent to which the Federal Reserve staff can rely on (1) the Federal Reserve’s review and assessment of key corporate governance, risk-management, and control functions, as well as material portfolios and business lines, of the consolidated HC; (2) assessments developed by the primary supervisor (when applicable) for business lines, risk management, control functions, or financial factors that are common to the Edge or agreement

21. The Federal Reserve is solely responsible for approving, and supervising the activities of, U.S. Edge and agreement corporations. As discussed in [SR-90-21](#), “Rating System For International Examinations,” one of the Federal Reserve’s supervisory responsibilities is the assignment of a CAMEO rating (Capital, Asset Quality, Management, Earnings, and Operations and Internal Controls) to each Edge and agreement corporation.

corporation and its parent bank; and (3) findings developed by host-country supervisors for activities under their jurisdiction.

In addition, where the primary supervisor of an Edge or agreement corporation's parent bank relies on the Federal Reserve's understanding and assessment in order to develop its CAMELS rating, the Federal Reserve will work to fulfill that supervisor's information needs.<sup>22</sup>

1050.2.4.6 Nontraditional Holding Companies

*Objectives:* A small number of regional HCs are considered to be nontraditional holding companies because most or all of their significant nondepository subsidiaries are regulated by a functional regulator, and subsidiary depository institutions are small in relation to the nondepository entities. As with all HCs, the level of analysis conducted and resources needed to supervise and assess nontraditional HCs should be commensurate with the level of risk posed by the organization's depository institution subsidiaries to the federal safety net and the level of risk posed by the parent or its nonbank subsidiaries to the HC's subsidiary depository institutions.

Due to the unique structure of nontraditional HCs, a single functional regulator is likely to have a complete view of, and ability to address, significant aspects of the organization's firmwide activities, risks, risk management, and controls. Therefore, assessments and information developed by the primary functional regulator typically will be the main tool utilized by the Federal Reserve in developing and assigning the "R" and "F" components of the consolidated RFI rating. More independent Federal Reserve work typically will be required to review and assess the impact of the nondepository entities on the subsidiary depository institutions in order to assign the "I" rating.

*Supervisory Activities:* The Federal Reserve will primarily utilize continuous monitoring activities to maintain its assessments of risk management and financial condition for nontraditional

HCs, relying on the assessments and information developed by the primary functional regulator to the fullest extent possible.

In addition to continuous monitoring, periodic testing will be used to perform an assessment of the potential negative impact of nonbank entities on subsidiary depository institutions as discussed in subsections 1050.2.3.3.1 and 1050.2.3.3.2 on, respectively, "Risk Management and Financial Condition of Significant Nonbank Subsidiaries" and "Parent Company and Nonbank Funding and Liquidity." In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described in subsection 1050.2.1.2.

1050.2.5 RELYING ON THE WORK OF OTHER REGULATORS

The principle of relying on the work of the insured depository institution (IDI) regulator is a well-established tenet of Federal Reserve supervisory policy and is required by statute.<sup>23</sup> Therefore, holding company supervision focuses on the Federal Reserve's assessment of the consolidated organization based on a review of parent and nonbank activities, together with an assessment of the organization's IDI subsidiaries. When assigning Federal Reserve supervisory ratings to a holding company, the Federal Reserve will rely to the fullest extent possible on the assessment of the IDI as reflected in the examination work performed by the IDI regulator(s).

The Federal Reserve tailors its supervision of holding companies based on the asset size of the organization, complexity, and the degree of systemic risk that the organization poses to the U.S. financial system and the economy, including the deposit insurance fund. Within this framework of tailored supervision, the Federal Reserve focuses on the goals of both macroprudential and microprudential supervision for systematically important institutions, and microprudential

22. The U.S. banking agencies assign CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) ratings to U.S. banking organizations as part of their ongoing supervision of these organizations. See SR-96-38, "Uniform Financial Institutions Rating System," as well as the *Commercial Bank Examination Manual*.

23. For the purpose of this guidance, "IDI regulator" is defined as the prudential bank regulator(s) other than the Federal Reserve, which includes the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the state banking supervisory authorities.

Refer to sections 5(c)(1)–(2) of the Bank Holding Company Act of 1956 (BHC Act) and sections 10(b)(2) and (b)(4) of the Home Owners' Loan Act (HOLA), as amended by section 604 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). 12 U.S.C. 1844(c)(1)–(2); 12 U.S.C. 1467a(b)(2), (b)(4).

supervisory goals for a holding company with total consolidated assets of less than \$100 billion.<sup>24</sup>

The BHC Act and the HOLA authorize the Federal Reserve to conduct examinations of holding companies, and certain subsidiaries of such holding companies, to obtain information needed to assess the safety and soundness of supervised financial institutions.<sup>25</sup> Further, the Dodd-Frank Act requires the Federal Reserve, to the fullest extent possible, to rely on the reports and supervisory information from other regulatory agencies to avoid duplication of examination activities, reporting requirements, and requests for information. Supervisory overlap at the level of the IDI can be avoided through reliance on the examination work performed by the IDI regulators, as each agency follows similar rules and supervisory guidance when assessing the financial and managerial condition of an insured depository institution.

Consistent with this mandate to rely on the work of the IDI regulators, the IDI regulators and the Federal Reserve have the mutual responsibility to foster the timely sharing of information, including their risk-focused supervisory analysis and conclusions. Moreover, the sharing of information is necessary so that Federal Reserve staff have an adequate basis for relying on the IDI regulators' work. While exercising the Federal Reserve's responsibility to assess and assign appropriate supervisory ratings to the consolidated holding company, the microprudential supervision framework for smaller holding companies provides the Federal Reserve with the flexibility to rely on the assessment of an IDI's condition by another regulator.

The following guidance explains the Federal Reserve's supervisory expectations for relying

on the work of the IDI regulators in the supervision of regional holding companies.<sup>26</sup> Refer to [SR-16-4](#).

### 1050.2.5.1 Relying on the Work of IDI Regulators for Regional Banking Organizations

The Federal Reserve supervises regional banking organizations (RBOs) using a program of continuous oversight which is characterized by a series of targeted examinations during the annual supervisory cycle, a roll-up examination at the end of the cycle, and continuous monitoring between examination events during the cycle.

1. Taking into account a holding company's complexity, risk profile, and condition, the Federal Reserve will rely to the fullest extent possible on the work of the IDI regulators to supplement its own supervisory work regarding the consolidated holding company and its nonbank subsidiaries.
2. Federal Reserve staff will promote the sharing of information with the IDI regulators throughout the supervisory cycle, which will foster collaborative interagency relationships. Federal Reserve staff and the IDI regulators generally may participate on each other's inspections and examinations to support and complement each other's work as necessary. Through ongoing dialogue and exchange of supervisory documents and information, Federal Reserve staff are expected to:
  - understand the IDI regulators' risk assessment and supervisory plan for each IDI, to include this information in the Federal Reserve's evaluation of consolidated holding company risk, and to support development of the Federal Reserve's supervisory plan for the holding company;
  - understand the IDI regulators' examination work, including the scope, basis for, and support of conclusions reached, and the goal of any supervisory action;
  - communicate to the IDI regulators the Federal Reserve's supervision goals and approach with respect to the holding company and any subsidiaries not subject to the supervision of IDI regulators; and

24. While recognizing that a large number of smaller asset-sized holding companies simultaneously experiencing financial distress could have a harmful effect on a local economy's availability of credit or on certain sectors or regions of the U.S. economy, institutions that are not systemically important do not have the size or degree of interconnectedness to the financial system to individually pose macroprudential risk.

25. 12 U.S.C. 1844(c)(2); 12 U.S.C. 1467a(b)(4)(A). This information pertains to the nature of the operations and financial condition of the holding company and its subsidiaries; the financial, operational, and other risks within the holding company system that may pose a threat to the safety and soundness of the holding company or of any depository institution subsidiary of the holding company, or the stability of the financial system of the United States; the systems of the holding company for monitoring and controlling any such risks; and the holding company's and subsidiaries' compliance with federal law, other than in the case of an insured depository institution or functionally regulated subsidiary.

26. The guidance in SR-16-4 also applies to any U.S. bank holding company with total consolidated assets of less than \$50 billion that is owned or controlled by a foreign banking organization.

- use all information made available from the IDI regulators to reach conclusions regarding the consolidated holding company's overall condition and to assign appropriate Federal Reserve supervisory ratings.
3. Federal Reserve staff should verify that the supervisory ratings of the consolidated holding company are adequately supported by information that is timely and complete, including the information received from the IDI regulators.
  4. Federal Reserve staff will scale their supervisory approach, including the review of and reliance on the IDI regulators' work, according to the complexity,<sup>27</sup> risk, and condition of the consolidated organization, and to the timeliness of information available from the IDI regulators. For noncomplex holding companies with satisfactory supervisory ratings, Federal Reserve consolidated ratings should rely heavily on the IDI regulators' work for IDI subsidiaries exhibiting the following characteristics:
    - CAMELS Composite 1 or 2;
    - low or moderate risk profiles;
    - stable financial condition;
    - satisfactory management practices and an associated satisfactory management component rating; and
    - IDI regulator examination reports issued within the past year.

In these situations, the Federal Reserve expects to limit its supervisory work to verify that the holding company can serve as a source of strength to, and the non-bank subsidiaries do not pose a threat to, the safety and soundness of the IDI(s). Thus, Federal Reserve staff will likely need to perform only limited analysis outside of the required annual holding company inspection of the parent and nonbank subsidiaries. In addition, this analysis will be supplemented by the Federal Reserve's continuous monitoring process.

In other situations, the Federal Reserve will scale its supervisory approach, including performing more detailed monitoring of a consolidated holding company's internal management information systems, internal audit, and loan review reports, depending on the company's complexity, risk, condition of the consolidated organization, and timeliness of information available from the IDI regulator. For example, a holding company with the following characteristics is a candidate for closer Federal Reserve supervision to ensure the conclusions reached by the IDI regulators remain a valid basis for assigning the supervisory ratings to the consolidated holding company:

- the IDI examination reports are not current;<sup>28</sup>
  - the composite rating for the holding company or any of its IDI subsidiaries is less than satisfactory; or
  - the holding company has deteriorating financial or risk trends that are not reflected in the most current IDI regulators' examination reports.
5. If Federal Reserve staff do not have an adequate basis for relying on the IDI regulators' supervisory findings, the Federal Reserve will work to resolve information gaps with the IDI regulators.<sup>29</sup>

#### 1050.2.6 INSPECTION REPORT CONTENT FOR CERTAIN HOLDING COMPANIES IN THE REGIONAL BANKING ORGANIZATION PORTFOLIO

Reserve Bank supervision staff should document in a report of inspection the conclusions reached in assigning the holding company rating components and subcomponents at full-scope or roll-up inspections of bank and savings and loan holding companies in the RBO portfolio. This subsection describes the content that examiners

27. The Federal Reserve distinguishes between complex and noncomplex holding companies by evaluating a number of factors, including: the size and structure of the company; the extent of intercompany transactions between IDI subsidiaries and the holding company or its non-depository subsidiaries; the risk, scale, and complexity of activities of any non-depository subsidiaries; and the degree of leverage at the holding company, including the extent of debt outstanding to the public. Companies are also designated "complex" if material risk-management processes for the holding company and its affiliates are consolidated at the parent company.

28. For the purpose of this guidance, RBO IDI examination reports that are not current are defined as reports older than one year, measured from the mailing date of an IDI regulator's report to the start date of the Federal Reserve supervisory evaluation.

29. In rare and limited circumstances, where unresolved information gaps exist or reliance upon information obtained from the IDI regulators does not sufficiently support the Federal Reserve's supervision of a consolidated holding company, the Federal Reserve would consider invoking its expanded examination authority under section 5(c)(2) of the BHC Act and section 10(b)(4) of the HOLA, as amended by section 604 of the Dodd-Frank Act, to examine IDIs for which the Federal Reserve is not the primary regulator. 12 U.S.C. 1844(c)(2); 12 U.S.C. 1467a(b)(4).

should include in a roll-up or full scope inspections for institutions with the following characteristics:

- The holding company has between \$10 billion and \$100 billion in total consolidated assets;
- The holding company is noncomplex; and
- The lead IDI subsidiary of the holding company is not a state member bank.<sup>30</sup>

For complex holding companies that have total consolidated assets between \$10 billion and \$100 billion, Reserve Bank examiners may develop a report of inspection based on this outline, and include other inspection report pages, as necessary, to document supervisory activities completed to assign a rating. For holding companies with lead state member bank subsidiaries, supervision staff should generally utilize a combined examination/inspection report.

Sections marked with an asterisk (\*) should be omitted from the report if they are not applicable.

- I. Overview (see [1050.2.6.1](#))
- II. Scope (see [1050.2.6.2](#))
- III. Summary of Inspection Conclusions (see [1050.2.6.3](#))
- IV. Ratings (Overall Composite Rating) (see [1050.2.6.4](#))
- V. Violations of Law\* (see [1050.2.6.5](#))
- VI. Matters Requiring Attention\* (see [1050.2.6.6](#))
- VII. Risk Management (see [1050.2.6.7](#))
  - a. Board and Senior Management Oversight
  - b. Policies, Procedures, and Limits
  - c. Risk Monitoring and Management Information Systems
  - d. Internal Controls
- VIII. Financial Condition (see [1050.2.6.8](#))
  - a. Capital
  - b. Asset Quality
  - c. Earnings
  - d. Liquidity
- IX. Impact (see [1050.2.6.9](#))
- X. Depository Institution (see [1050.2.6.10](#))
- XI. Other Matters\* (see [1050.2.6.11](#))
- XII. Closing Comments (see [1050.2.6.12](#))
- XIII. Signatures of Directors (see [1050.2.6.13](#))

30. However, examiners may follow the inspection report outline—presented in this subsection of the manual—when the holding company report of inspection is issued separately from the lead state member bank report of examination.

### 1050.2.6.1 Overview

This section includes basic information about the supervisory event or inspection. It should include the type of event (such as a full-scope inspection) as well as the timeframes of the event. This section should also indicate the date the Reserve Bank met with representatives from the institution to discuss the inspection report as well as the names of the meeting participants.

### 1050.2.6.2 Scope

This section of the report explains the breadth of the supervisory event. The scope of the report should note the specific areas or business lines that were reviewed. The Scope section of the report should state the Federal Reserve's statutory authority for completing the inspection (e.g., section 5(c) of the Bank Holding Company Act of 1956).

The Scope section should describe some of the information examiners reviewed to develop their assessment of the parent company's ability to support and act as a source of strength to its subsidiary institution, board and senior management oversight and the governance structure, and the consolidated financial condition of the organization. Common sources of information include:

- minutes of the board of directors' and related committee meetings;
- corporate policies of the holding company;
- financial statements of the parent and subsidiary depository institution;
- management information systems (MIS); and
- IDI regulator's work.<sup>31</sup>

### 1050.2.6.3 Summary of Inspection Conclusions

This section of the inspection report provides the overall ratings, assessment of the institution's financial condition and risk management, as well as any key supervisory messages.

31. For more information, see 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."

1050.2.6.4 Ratings

This section describes the overall condition of the holding company as well as the composite rating of the institution as defined in the Federal Reserve System’s RFI/C(D) holding company rating system.<sup>32</sup> Composite, component, and subcomponent ratings are assigned based on a 1 to 5 numeric scale. A “1” indicates the highest rating, strongest performance and practices, and least degree of supervisory concern; a “5” indicates the lowest rating, weakest performance, and highest degree of supervisory concern. This section also contains a table listing the composite, component, and subcomponent RFI/C(D) ratings assigned to the company at this inspection, as well as the ratings assigned at the two prior inspections (see [table 1](#)). The possible composite rating definitions are as follows:

**Rating 1 (Strong).** Holding companies in this group are sound in almost every respect; any negative findings are basically of a minor nature and can be handled in a routine manner. Risk-management practices and financial condition provide resistance to external economic and financial disturbances. Cash flow is more than adequate to service debt and other fixed obligations, and the nondepository entities pose little risk to the subsidiary depository institution(s).

**Rating 2 (Satisfactory).** Holding companies in this group are fundamentally sound but may have modest weaknesses in risk-management practices or financial condition. The weaknesses could develop into conditions of greater concern but are believed correctable in the normal course of business. As such, the supervisory response is limited. Cash flow is adequate to service obligations, and the nondepository entities are unlikely to have a significant negative impact on the subsidiary depository institution(s).

**Rating 3 (Fair).** Holding companies in this group exhibit a combination of weaknesses in risk-management practices and financial condition that range from fair to moderately severe. These companies are less resistant to the onset of adverse business conditions and would likely deteriorate if concerted action is not effective in correcting the areas of weakness. Consequently,

these companies are vulnerable and require more than normal supervisory attention and financial surveillance. However, the risk management and financial capacity of the company, including the potential negative impact of the nondepository entities on the subsidiary depository institution(s), pose only a remote threat to its continued viability.

**Rating 4 (Marginal).** Holding companies in this group have an immoderate volume of risk management and financial weaknesses, which may pose a heightened risk of significant negative impact on the subsidiary depository institution(s). The holding company’s cash flow needs may be being met only by upstreaming imprudent dividends and/or fees from its subsidiaries. Unless prompt action is taken to correct these conditions, the organization’s future viability could be impaired. These companies require close supervisory attention and substantially increased financial surveillance.

**Rating 5 (Unsatisfactory).** The critical volume and character of the risk management and financial weaknesses of holding companies in this category, and concerns about the nondepository entities negatively impacting the subsidiary depository institution(s), could lead to insolvency without urgent aid from shareholders or other sources. The imminent inability to prevent liquidity and/or capital depletion places the holding company’s continued viability in serious doubt. These companies require immediate corrective action and constant supervisory attention.

1050.2.6.5 Violations of Law\*

If violations of statutes or regulations were identified during the inspection, this section should describe the statute or regulation and the conditions or circumstances that led to the violation. Examiners should indicate whether the violation is isolated (management generally understands the statute or regulation but missed one instance) or systemic (management was not aware of or did not understand fully the statute or regulation). Further, examiners should describe the institution’s corrective action taken or planned.

1050.2.6.6 Matters Requiring Attention\*

This section should be included in the inspection report if there are findings from the inspection or previous inspection. Supervisory findings may consist of Matters Requiring Immediate

32. See SR-19-4/CA-19-3, “Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than \$100 billion,” for more information on the descriptions and definitions of the RFI/C(D) component and subcomponent ratings.

Table 1. Holding Company Ratings

[Holding Company Name]	Current Inspection MM/DD/YYYY	Prior Inspection MM/DD/YYYY	Prior Inspection MM/DD/YYYY
<b>R – Risk Management</b>			
<i>Subcomponents:</i>			
Board and Senior Management Oversight			
Policies, Procedures, and Limits			
Risk Monitoring and MIS			
Internal Controls			
<b>F – Financial Condition</b>			
<i>Subcomponents:</i>			
Capital			
Asset Quality			
Earnings			
Liquidity			
<b>I – Impact of Parent and Non-Depository Subsidiaries on Depository Institution</b>			
<b>C – Composite Rating</b>			
<b>(D) – Depository Institution</b>			

Attention (MRIA) and Matters Requiring Attention (MRA). The key distinction between MRIsAs and MRAs is the nature and severity of matters requiring corrective action, as well as the immediacy with which the banking organization must begin and complete corrective actions. This section should address newly identified MRIsAs and/or MRAs, as well as the status of all other MRIsAs/MRAs that were open at the beginning of the inspection. Reserve Banks can also provide history of MRIsAs/MRAs addressed during the supervisory cycle. Examiners may include subheadings in this section to differentiate (1) MRIsAs; (2) MRAs; and (3) status of prior MRIsAs and MRAs.

Examiners should refer to [SR-13-13/CA-13-10](#), “Supervisory Considerations for the Communication of Supervisory Findings,” for guidance on standardized language, timeframes and supervisory follow-up for MRIsAs and MRAs. Further, when issuing a supervisory finding (including through the issuance of an MRIA or MRA), examiners will *not* criticize an institution for a “violation” of supervisory guidance (as supervisory guidance is not legally binding). When appropriate, examiners may reference (including in writing) supervisory guidance to provide examples of safe-and-sound conduct, appropriate risk-management practices, and other approaches to addressing compliance with applicable statutes or regulations.<sup>33</sup>

1050.2.6.7 Risk Management  
*[Assign a Rating 1 to 5]*

In this section of the report, examiners are expected to provide a qualitative description of the institution’s risk management (R component), and subcomponent ratings. The risk-management rating contains four subcomponents to guide examiners in the assessment of the effectiveness of the holding company’s risk management and controls. The subcomponents are (1) Board and Senior Management Oversight; (2) Policies, Procedures, and Limits; (3) Risk Monitoring and Management Information Systems; and (4) Internal Controls. Examiners can generally complete a brief overview summarizing the risk-management subcomponent ratings in one paragraph. In situations where Risk Management or any subcomponents are rated “3” or worse, or otherwise require emphasis, examiners may consider including information on the deficiencies into the introductory comment before providing a more comprehensive discussion and assessment of the holding company within the four risk-management subcomponent ratings.

Board and Senior Management Oversight  
*[Assign a Rating 1 to 5]*  
Examiners are to evaluate the adequacy and effectiveness of board and senior management

oversight and management’s capabilities including the ability to identify and understand corporate risks, hire competent staff, and respond to changes in the organization’s risk profile or the banking sector. Examiners should consider corporate governance, strategic planning, capital planning, budgeting process, and responsiveness to auditors and supervisory authorities.

Policies, Procedures, and Limits

*[Assign a Rating 1 to 5]*

Examiners should describe their assessment of the holding company’s policies, procedures, and limits given the risks inherent in the organization’s activities and stated goals and objectives.

Risk Monitoring and Management Information Systems

*[Assign a Rating 1 to 5]*

Examiners are to evaluate the adequacy of risk measurement and monitoring, management reports, information systems including the assumptions, data, and procedures used to measure risk and the consistency of these tools with the complexity of the organization’s activities.

Internal Controls

*[Assign a Rating 1 to 5]*

Examiners are to assess the adequacy of internal controls and audit, including the accuracy of financial reporting and disclosure, the strength and influence of audit, the independence of control areas from management, and the consistency of audit scopes relative to the organization’s complexity.

1050.2.6.8 Financial Condition

*[Assign a Rating 1 to 5]*

The financial condition component (F component) is supported by four subcomponents reflecting an assessment of the quality of the holding company’s Capital; Asset Quality; Earnings; and Liquidity. In this section, examiners should provide a qualitative write-up for the financial condition subcomponents. Examiners may add tables with financial ratios and other analyses, as necessary. In situations where Financial Condition or any subcomponents are rated “3” or worse, or otherwise require emphasis, examiners may include information on the deficiencies into the introductory comment, with more detailed comments reserved for discussion under

separate subheadings, or in the applicable supplemental report page.

Capital

*[Assign a Rating 1 to 5]*

Examiners should describe the adequacy of the organization’s consolidated capital position from a regulatory capital perspective. (See for example, 12 CFR part 217 and 12 CFR part 225.) The evaluation of capital adequacy will consider the risk inherent in an organization’s activities and the ability of capital to absorb unanticipated losses, to provide a base for growth, and to support the parent company and subsidiaries’ debt. Also discuss the capital planning process, and capital management objectives viewed in accordance with applicable statutes and regulations.<sup>34</sup>

Asset Quality

*[Assign a Rating 1 to 5]*

Examiners should assess the quality of the organization’s consolidated assets. The evaluation will include, as appropriate, both on-balance sheet and off-balance sheet exposures, and the level of classified and nonperforming assets. Forward-looking indicators of asset quality, such as the adequacy of underwriting standards, the level of concentration risk, the adequacy of credit administration policies and procedures, and the adequacy of management information systems for credit risk may also form the Federal Reserve’s view of asset quality. Also assess the adequacy of the allowance at the parent company level if applicable.

Earnings

*[Assign a Rating 1 to 5]*

In assessing the quality and sustainability of consolidated earnings, examiners should consider the level, trend, and sources of earnings, as well as the ability of earnings to augment capital as necessary, to provide ongoing support for a bank holding company’s activities. In addition, examiners should assess material nonrecurring income and expense items, and adjust the return on average assets accordingly.

Liquidity

*[Assign a Rating 1 to 5]*

Examiners should describe the consolidated organization’s ability to attract and maintain the sources of funds necessary to support its opera-

34. For more background information, see [SR-09-4](#), “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies.”

tions and meet its obligations. Further examiners should evaluate the funding conditions for each of the material legal entities in the holding company structure and determine whether any weaknesses exist that could affect the funding profile of the consolidated organization.<sup>35</sup>

### 1050.2.6.9 Impact *[Assign a Rating 1 to 5]*

The Impact, or I component, is an assessment of the potential impact of the nondepository entities on the subsidiary depository institution(s). The depth of analysis for this component rating will depend on the complexity of the organization. In supporting the Impact component rating, examiners should describe general activities and profiles of the parent company and nonbank entities. Examiners should evaluate the risk-management practices and financial condition of the nondepository entities. The assessment of the I component includes an assessment of the following key areas:

#### *Parent Company Financial Analysis*

- Examiners should determine whether the parent company is reasonably positioned to serve as a source of strength to the depository institution subsidiaries.
- Examiners should assess the level and adequacy of parent company cash flow by:
  - Identifying the level, structure and terms of debt instruments; as well as total quarterly or annual debt service requirements.
  - Determining whether the parent company's cash flow position (current and projected) is sustainable.
- Examiners should review and evaluate the parent company's dividend policy and dividend payment by assessing:
  - The appropriateness of dividends paid by the parent company to its shareholders.<sup>36</sup>
  - The reasonableness of dividend payments of the subsidiaries to the parent company in relation to each subsidiary's capital needs.

35. For more background information on assessing liquidity see [SR-10-6](#), "Interagency Policy Statement on Funding and Liquidity Risk Management," (75 Fed. Reg. 13,656 (March 22, 2010)).

36. For more background information, review the Board's Policy Statement on Cash Dividend Payments (For the text on the Board's policy statement "Unsound Banking Practices—Cash Dividends Not Fully Covered by Earnings," (November 14, 1985) see Attachment B to SR-09-4, and this manual's section entitled, "Intercompany Transactions (Dividends)."

- Examiners should discuss the parent company's liquidity position including the composition and level of available funding sources and the adequacy of contingency funding planning.

#### *Intercompany Transactions*

Examiners should comment on:

- The relationships and transactions between and among affiliated entities including assessing compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W (12 CFR part 223).
- Intercompany transactions, and whether they were undertaken at arm's length and that consistency and fairness are demonstrated.
- The reasonableness of fees charged by a parent company and/or nonbank subsidiary by examining the services provided and the basis for allocating fees.

### 1050.2.6.10 Depository Institution *[Assign a Rating 1 to 5]*

This rating generally reflects the composite CAMELS rating assigned by the lead subsidiary Depository Institution's (DI's) primary regulator. In a multi-depository institution holding company, this rating will reflect a weighted average of the CAMELS composite ratings of the individual subsidiary depository institutions, weighted by both asset size and the relative importance of each depository institution within the holding company structure. Risk management and financial matters for the DI's are generally covered above and comments should not be redundant. A summary of the DI's condition is not required unless a rating deviates from that of the primary regulator, but a brief discussion of problem DIs may be appropriate.

### 1050.2.6.11 Other Matters\*

This section, which should be omitted if not applicable, includes a discussion of risk management of areas such as Bank Secrecy Act (BSA), information technology, assessment of the organization's response to any supervisory action(s), or other supervisory matters deserving specific attention. Consumer compliance issues

that affect risk management should be addressed under the appropriate risk-management subcomponent.

1050.2.6.12 Closing Comments

This section of the inspection report should instruct the institution’s board and senior management to review the report of inspection and that the directors should sign the Signature of Directors page. The report should also indicate that the institution should retain the report in its records.

If there are supervisory findings, this section should indicate that the holding company is to provide a written response to the Reserve Bank that describes plans for addressing the findings. Depending on the circumstances, the report may indicate that Reserve Bank staff will schedule a formal presentation at an upcoming scheduled board of directors meeting to communicate the inspection report findings and answer questions regarding any possible supervisory findings.

The section should also include standard language indicating that any institution about which the Federal Reserve makes a written material supervisory determination is eligible to use the appeals process as described in “Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System.”<sup>37</sup> An appeal under this process may be made of any written material supervisory determination, as defined in the policy statement. It should also provide the contact information for the Board’s Ombudsman.

Lastly, this section should note that the contents of the report are confidential and should not be made public.

1050.2.6.13 Signature of Directors

The signature of directors page demonstrates that the board of directors received and reviewed the report of inspection.

37. 85 Fed. Reg. 15,175 (March 17, 2020) and [SR-20-28/CA-20-14](#), “Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System.”

1050.2.7 COMBINED ROLL-UP REPORT FOR REGIONAL BANKING ORGANIZATIONS

1050.2.7.1 Applicability, Purpose, and Outline of the Report

This manual subsection describes the content in the Combined Roll-Up Report. Examiners should use the Combined Roll-Up Report for regional banking organizations (RBOs) that are bank holding companies (BHCs) with a lead bank subsidiary that is a state member bank (SMB), and the following conditions apply:

- The Reserve Bank was the lead regulatory agency completing the statutorily required full-scope examination of the SMB;<sup>38</sup> and
- The BHC’s board has formally approved a combined report being released to its lead SMB subsidiary.<sup>39</sup>

The purpose of the Combined Roll-Up Report is to increase efficiencies when completing the roll-up supervisory assessment of a BHC with a SMB subsidiary.<sup>40</sup> The Combined Roll-Up Report comments on the condition of the holding company, as well as the SMB, which likely possesses similar risk characteristics. Furthermore, in many cases, most of the assets of the consolidated BHC are held at the bank subsidiary. As such, many of the sections in the Combined Roll-Up Report are similar in form and function to the sections in the RBO holding company report described earlier in this manual section, as well as the examination report for RBO SMBs (see section 1002.1 of the *Commercial Bank Examination Manual*). In addition, the Combined Roll-Up Report aligns with the interagency principles on completing reports of examination.<sup>41</sup>

Other general report completion principles that apply to the Combined Roll-Up Report are as follows:

38. In cases where the BHC has more than one SMB subsidiary, separate examination reports should be prepared for all other state member bank subsidiaries.

39. If the BHC’s board wishes to receive a combined report, it should formally approve the release of the combined report to its lead SMB subsidiary by board resolution.

40. The Combined Roll-Up Report should not be used to communicate the conclusions of target examination or instances when there are state banking agency requirements that preclude the use of the Combined Roll-Up Report. In such instances, examiners should reference the RBO report template in the *Commercial Bank Examination Manual*.

41. See [SR-19-6](#), “Federal Financial Institutions Examination Council Policy Statement on the Principles for Completing the Report of Examination.”

- The scope and depth of matters discussed under a section will vary based on the underlying issues and areas of concern presented as well as on their severity.
  - For example, written conclusions for BHCs rated composite “1” or “2” under the RFI Rating System and SMBs rated “1” or “2” under the Uniform Financial Institutions Rating System will generally be more concise than for institutions rated a composite “3,” “4,” or “5.”
- The most important comments should be described first.
- Comments should be provided primarily on areas of the institution’s operations and aspects of its financial condition that display weaknesses, deficiencies, or vulnerabilities. While examiners may recognize positive actions taken by management, particularly those related to actions taken by management in relation to prior supervisory matters, laudatory or conclusive remarks and endorsements of specific management actions should be avoided. Furthermore, any contextual statements or comments should support the conclusion in the report.
- In all instances, the report should explain that the contents contain confidential supervisory information and that the Board has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in the law (12 U.S.C. 1817(a) and 1831m) and implementing regulations (12 CFR pt. 261, subpart C). This information may be conveyed on the report cover sheet or in a footnote reference in the report.

Below is an outline of the Combined Roll-Up Report. Sections and subheadings listed below are required to be included in Combined Roll-Up Report, unless they are marked with an asterisk (\*). Sections or sub-headings marked with an asterisk should be omitted from the report if they are not applicable.

- I. Directorate Responsibility (see [1050.2.7.2](#))
- II. Scope (see [1050.2.7.3](#))
- III. Overall Risk Profile, Conclusions, and Key Supervisory Themes (see [1050.2.7.4](#))
  - a. Overall Risk Profile\*
  - b. Overall Conclusions
  - c. Holding Company Rating
  - d. Bank Rating
  - e. Key Supervisory Themes\*
- IV. Summary of Ratings (see [1050.2.7.5](#))

- V. Apparent Violations of Law\* (see [1050.2.7.6](#))
- VI. Supervisory Issues\* (see [1050.2.7.7](#))
  - a. Matters Requiring Immediate Attention (MRIs)\*
  - b. Matters Requiring Attention (MRAs)\*
  - c. Status of Prior MRIs/MRAs\*
- VII. Compliance with Enforcement Action(s)\* (see [1050.2.7.8](#))
- VIII. Consolidated Management and Risk Management (see [1050.2.7.9](#))
- IX. Consolidated Financial Condition (see [1050.2.7.10](#))
- X. Impact and Depository Institution(s) (see [1050.2.7.11](#))
  - a. Impact
  - b. Depository Institution(s)
- XI. Information Technology Assessment\* (see [1050.2.7.12](#))
- XII. Fiduciary Activities Assessment\* (see [1050.2.7.13](#))
- XIII. Consumer Compliance Assessment (see [1050.2.7.14](#))
- XIV. Additional Supervisory Assessments (see [1050.2.7.15](#))
  - a. Bank Secrecy Act/Anti-Money Laundering Compliance Program
  - b. Audit Program\*
  - c. Other Matters\*
- XV. Signature of Directors (see [1050.2.7.16](#))

### 1050.2.7.2 Directorate Responsibility

This section informs board members that they are responsible for thoroughly reviewing the report and that each director must sign the Signature of Directors section at the conclusion of this report. This section also includes standard language informing the organization of its right to appeal material supervisory determinations. This standard language can be placed in the body of the report or in a footnote. See the *Federal Register* for more information on the Federal Reserve’s appeals process (85 Fed. Reg. 15,175 (March 17, 2020)).<sup>42</sup>

42. See also [SR-20-28/CA-20-14](#), “Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System.”

1050.2.7.3 Scope

This section of the report explains the breadth of the roll-up supervisory event as it relates to both the SMB and the BHC. The Scope section of the report should note the specific areas or business lines that were reviewed. In general, the section should contain two concise paragraphs discussing the inspection/examination scope, including management information systems (MIS) reviewed and meetings conducted. Furthermore, the Scope section of the report should state the Federal Reserve’s statutory authority for completing the inspection and examination, namely

- section 5(c) of the Bank Holding Company Act of 1956 and
- section 9(7) of the Federal Reserve Act.

The Scope section should also describe the exit meeting between representatives from the organization and the supervisory agencies. The exit meeting description should include the date of the meeting and the meeting attendees, such as Reserve Bank and other regulatory agency and organization representatives, including affiliations and titles.

1050.2.7.4 Overall Risk Profile, Conclusions, and Key Supervisory Themes

This overall section is required to be included in the Combined Roll-Up Report. However, depending on the circumstances, some of the subheadings (indicated with an asterisk) may be omitted from the Combined Roll-Up Report.

*Overall Risk Profile\**

If the bank and the BHC are both rated a composite “1” or “2,” this subheading is optional. This subheading is required if the bank and/or the BHC are rated a composite “3,” “4,” or “5.” In either case, this subheading is very concise, typically one paragraph in length. In terms of content, this subheading describes the organization’s overall risk profile within the context of the analysis that is described in the Overall Conclusions subheading below. This section should focus on the key activities that influence the risk profile and could include a discussion of

specific risk stripes.<sup>43</sup> However, this subheading should *not* include a risk matrix, nor should this subheading repeat information on the organization’s risk profile that is included in the sections on “Consolidated Management and Risk Management,” and “Consolidated Financial Condition.”

*Overall Conclusions*

This subheading describes the overall ratings and ratings support for the holding company and the bank. The subheading includes a supervisory assessment of the organization’s financial condition and risk management, as well as any key supervisory messages for the institution. This subheading’s content is concise, generally two paragraphs. If examiners need to expound on the key supervisory messages, they should include that discussion in the Key Supervisory Themes subheading below.

*Holding Company Rating*

Examiners should insert the composite rating definition for BHCs rated “3,” “4,” or “5.” Examiners are not required to insert the composite rating definitions for BHCs rated “1” or “2.” The section should include a reference to the appropriate guidance with the ratings definitions: [SR-19-4/CA-19-3](#), “Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than \$100 billion.”

*Bank Rating*

Examiners should insert the composite CAMELS rating definition for SMBs rated “3,” “4,” or “5.” Examiners are not required to insert the composite CAMELS rating definitions for SMBs rated “1” or “2.” The section should include a reference to the appropriate guidance with the ratings definitions: [SR-96-38](#), “Uniform Financial Institutions Rating System”; the *Commercial Bank Examination Manual*; or 61 Fed. Reg. 67,021 (December 19, 1996).

43. See [SR-16-11](#), “Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$100 Billion.”

### *Key Supervisory Themes\**

This section is optional and is included at the discretion of examination staff. Examiners should consider including the Key Supervisory Themes subheading based on the organization's condition, risk profile, the severity of findings, and other significant factors. Examiners can also use Key Supervisory Themes to communicate focus areas for the upcoming supervisory cycle. If there are multiple supervisory themes, examiners should describe each theme in concise paragraphs separating each of them with a header. Each Supervisory Theme should be significant to the financial or operating condition of the organization and/or its strategic direction. Possible Key Supervisory Themes could include

- describing the root causes for a significant volume or severity of findings (MRIs, MRAs, or apparent violations of law);
- indicating that an organization's risk profile raises more than normal supervisory concerns; or
- describing other material supervisory issues or matters that examiners want to communicate to the board and senior management.

### 1050.2.7.5 Summary of Ratings

The Summary of Examination Ratings report section is mandatory. In tabular format, examiners should include all supervisory ratings assigned during the current supervisory cycle and the two previous supervisory cycles. On the Summary of Ratings page, examiners should convey the following ratings, as applicable:

- for the BHC, the composite ratings, as well as the component and relevant subcomponent ratings that are part of the RFI rating system
- for the SMB, the composite and component CAMELS ratings, as well as the overall risk management rating
- any specialty area assessments, such as information technology, trust, and transfer agent examinations
- additional supervisory assessments (some of which do not have a ratings system associated with them), such as audit, BSA/AML compliance, consumer compliance, and Community Reinvestment Act

### 1050.2.7.6 Apparent Violations of Law\*

The Apparent Violations of Law section is optional. However, when examiners identify apparent violations of applicable banking statutes and regulations, it is mandatory to include this section in the report. If apparent violations of statutes or regulations were identified during the inspection, this section should describe the statute or regulation and the conditions or circumstances that led to the apparent violation. Examiners should indicate whether the apparent violation is isolated (management generally understands the statute or regulation but missed one instance) or systemic (management was not aware of or did not fully understand the statute or regulation). Further, examiners should describe the institution's corrective action taken or planned.

### 1050.2.7.7 Supervisory Issues\*

This section can be omitted if there are no prior open MRAs or MRIs (collectively "findings") at the SMB, BHC, or any nonbank subsidiary(ies) of the holding company and if no findings were identified in the current supervisory cycle. In general, this section conveys newly identified findings, as well as the status of all prior findings that were open at the beginning of the inspection/examination cycle. This section could potentially contain the following sub-headings: (1) Matters Requiring Immediate Attention, (2) Matters Requiring Attention, and (3) Status of Prior MRIs/MRAs.

For the "Matters Requiring Immediate Attention" and "Matters Requiring Attention" sub-headings, examiners should describe the findings from the current roll-up supervisory event and inform the institution to review the finding(s) and appropriately respond within the designated timeframe(s). The section should include a footnote to the relevant guidance that provides definitions of MRIs and MRAs.<sup>44</sup> The footnote should provide a reference to the Statement Clarifying the Role of Supervisory Guidance.<sup>45</sup>

44. SR-13-13/CA-13-10, "Supervisory Considerations for the Communication of Supervisory Findings."

45. See 12 CFR part 262, appendix A, which states that examiners will not criticize (through the issuance of matters requiring attention), a supervised financial institution for, and the Board will not issue an enforcement action on the basis of, a "violation" of or "non-compliance" with supervisory guidance.

The subheading on the “Status of Prior MRIAs/MRAs” should include a summary and status of all open findings from the start of the supervisory cycle as well as findings that were opened during the current supervisory cycle. This subheading should contain a table that conveys the following information:

- exact title of the finding that was communicated in a previous examination report or supervisory letter
- type of finding (MRIA/MRA)
- specific entity (e.g., bank, bank holding company, credit-extending nonbank subsidiary) that the finding identified
- date the finding was issued
- status (closed/open) of the finding
- expected date of completion for an open finding or the date of completion if the finding is closed

1050.2.7.8 Compliance with Enforcement Action\*

The Compliance with Enforcement Action section should be omitted if there are no open informal or formal enforcement actions at either the SMB or BHC. However, this section is required if there is an open formal or informal enforcement action for the bank and/or parent BHC and compliance with the enforcement action was assessed during the roll-up supervisory event. This section includes an assessment that summarizes the institution’s overall compliance with the enforcement action. Additionally, this section should include (1) all provisions of the enforcement action; (2) a concise description of actions taken to achieve compliance with each provision; and (3) the compliance status (in process, partial compliance, full compliance, noncompliance) of each provision. Examiners should follow the format of the enforcement action for this section.

If examination staff assessed compliance with the enforcement action prior to the roll-up supervisory event (but during the same supervisory cycle) and previously conveyed that assessment to the institution, this section in the Combined Roll-Up Report should contain a concise paragraph describing overall compliance with the enforcement action. Furthermore, the section in the Combined Roll-Up Report should provide a cross reference to the initial correspondence for additional information.

1050.2.7.9 Consolidated Management and Risk Management

This section is required as it explains the rationale for assigning the management rating of the SMB as well as the risk management rating of the BHC and SMB. Guidance for completing this section is provided in the subheadings below. Note that examiners may tailor the subheadings to reflect the structure of the organization or if certain activities are only performed within a certain legal entity (SMB or BHC). In this section, the Management rating applies to the SMB. The Risk Management rating applies to both the parent BHC and the SMB. The Risk Management sub-component ratings apply to the parent BHC.

*Management Rating*  
*[Assign a Rating 1 to 5]*

Examiners are to assign the numerical Management CAMELS component rating (1 to 5) of the SMB. Examiners are expected to provide a written description providing the rationale for the rating assigned. The Management assessment should include commentary on the composition and qualifications of the SMB board and senior management. Furthermore, this subheading can include commentary on governance structure.

*Risk Management Rating*  
*[Assign a Rating 1 to 5]*

Examiners are to assign the numerical Risk Management rating (1 to 5) of the SMB and the BHC. Examiners should explain the rationale for assigning the overall Risk Management rating. In situations where the Risk Management or any subcomponents are rated “3” or worse, examiners may describe the weaknesses or deficiencies in the introductory comment before providing a more comprehensive discussion and assessment within the four risk management subcomponent ratings. Examiners may use the introductory comment field to describe other matters that would otherwise require emphasis from the risk management perspective.

Furthermore, examiners are to assign the numerical ratings for the BHC’s Risk Management subcomponents, which include

- Board and Senior Management Oversight  
*[Assign a Rating 1 to 5]*
- Policies, Procedures, and Limits  
*[Assign a Rating 1 to 5]*

- Risk Monitoring and Management Information Systems *[Assign a Rating 1 to 5]*
- Internal Controls *[Assign a Rating 1 to 5]*

Under each component and subcomponent rating, examiners are expected to explain the rationale for assigning the rating.

#### 1050.2.7.10 Consolidated Financial Condition

This section is required and exhibits one of the primary benefits of using the Combined Roll-Up Report as it generally reduces the level of duplicative information that is provided to the organization. In this section, only the analysis for the Sensitivity to Market Risk focuses specifically on the activities of the SMB. The analysis and ratings of Consolidated Capital, Consolidated Asset Quality, Consolidated Earnings, and Consolidated Liquidity reflect the condition for both the BHC and the SMB, provided the ratings are the same at both entities.<sup>46</sup> The examiner should appropriately modify the headers below if the analysis cannot be completed on a consolidated basis, or if the financial ratings differ between the parent BHC and the SMB.

The outline of this section is as follows:  
Financial Condition –  
*[Assign a Rating 1 to 5]*

Examiners should explain the rationale for assigning the overall Financial Condition rating. Furthermore, for each financial component, examiners are expected to provide written support rationalizing the assigned rating. If examiners use reference tables to help justify ratings (e.g., capital, earnings, or liquidity ratios), examiners should not repeat this information in the supporting paragraph.

In situations where the Financial Condition Rating or any of the financial ratings are rated “3” or worse, examiners may describe the weaknesses or deficiencies in the introductory comment before providing a more comprehensive discussion and assessment as listed below.

- Consolidated Capital –  
*[Assign a Rating 1 to 5]*
- Consolidated Asset Quality –  
*[Assign a Rating 1 to 5]* (also see [table 2](#))

- Consolidated Earnings –  
*[Assign a Rating 1 to 5]*
- Consolidated Liquidity –  
*[Assign a Rating 1 to 5]*
- Sensitivity to Market Risk –  
*[Assign a Rating 1 to 5]*

#### 1050.2.7.11 Impact and Depository Institutions

This required section is divided into the following two subsections:

##### *Impact [Assign a Rating 1 to 5]*

The Impact, or I component, is an assessment of the potential impact of the nondepository entities on the subsidiary depository institution(s). In supporting the Impact component rating, examiners should describe general activities and profiles of the parent company and nonbank entities. Examiners should evaluate both the risk management practices and financial condition of the non-depository entities and assess the potential negative impact non-depository institution(s) and/or the parent company could directly or indirectly have upon the risk management or financial condition of subsidiary depository institution(s) now or in the future. The Impact assessment generally covers (1) Parent Company Financial Analysis; (2) Intercompany Transactions; and (3) Nonbank Subsidiaries. For more information on assessing this component rating, see [1050.2.6.9](#), “Impact.”

The depth of analysis will depend on the complexity of the organization, as well as any issues that were identified during the supervisory event. For BHCs rated “1” or “2,” the examiners should generally provide one paragraph of supporting comments in this subsection for each of the three key areas noted in the preceding paragraph.

##### *Depository Institutions [Assign a Rating 1 to 5]*

In most cases, the Depository Institution rating reflects the SMB subsidiary’s composite CAMELS rating. In a multi-depository institution holding company, this rating will reflect a weighted average of the CAMELS composite ratings of the individual subsidiary depository institution(s), weighted by both asset size and

46. For more information, see subsection 1050.2.6.8 “Financial Condition” in this section and section 1002.1 of the *Commercial Bank Examination Manual*.

Table 2. Summary of Items Subject to Adverse Classification

Organization	Substandard	Doubtful	Loss	Total
Parent				
Bank Subsidiaries				
Nonbank Subsidiaries				
Totals at Current Event <i>[Date]</i>				
Totals at Previous Event <i>[Date]</i>				
Totals at Previous Event <i>[Date]</i>				

the relative importance of each depository institution within the holding company structure. For more information on the assessment of the Depository Institution rating, see section 1062.0, “RFI Rating System” in this manual. In general, the comments in this subsection are brief as risk management and financial matters applicable to the subsidiary SMB are described in previous sections of the Combined Roll-Up Report.

1050.2.7.12 Information Technology Assessment\*  
*[Assign Composite Rating and Component Ratings 1 to 5]*

The Information Technology Assessment section is optional. The section is mandatory, however, if an information technology assessment was completed during the roll-up event and a rating was assigned.<sup>47</sup> In these instances, examiners should communicate the ratings that were assigned as well as the supporting rationale for the ratings. Information technology conclusions should only be reflected in the Consolidated Financial Condition or Consolidated Management and Risk Management sections of the report, when they are significant contributing factors to the overall financial condition or the management or risk management rating components. In addition, significant supervisory concerns should be reflected in the Supervisory Issues section.

If examiners communicated to the institution the conclusions of an information technology assessment or examination in a separate report or supervisory letter, the Combined Roll-Up Report should contain a concise paragraph of the report conclusions from that assessment

under the “Additional Supervisory Assessments” section (see [1050.2.7.15](#)).

1050.2.7.13 Fiduciary Activities Assessment\*  
*[Assign Composite Rating and Component Ratings 1 to 5]*

The Fiduciary Activities Assessment section is optional. The section is mandatory, however, if a fiduciary activities assessment was completed during the roll-up event and a trust or transfer-agent rating was assigned.<sup>48</sup> In these instances, examiners should communicate the ratings that were assigned as well as the supporting rationale for the ratings. Fiduciary activities conclusions should only be reflected in the Consolidated Financial Condition or Consolidated Management and Risk Management sections of the report when they are significant contributing factors to the overall financial condition or the management or risk management rating components. Significant supervisory concerns should be reflected in the Supervisory Issues section.

If examiners communicated to the institution the conclusions of a trust or transfer agent examination in a separate report or supervisory letter, the Combined Roll-Up Report should contain a concise paragraph of the report conclusions from that assessment under the “Additional Supervisory Assessments” section (see [1050.2.7.15](#)).

1050.2.7.14 Consumer Compliance Assessment

This section is typically based on supervisory assessments that are completed by Federal Reserve examiners in consumer affairs. When a consumer compliance assessment is conducted during the supervisory cycle, safety-and-

47. See [SR-99-8](#), “Uniform Rating System for Information Technology,” and 64 Fed. Reg. 3109 (January 20, 1999) for more information.

48. See [SR-98-37](#), “Uniform Interagency Trust Rating System,” and 63 Fed. Reg. 54,704 (October 13, 1998) for more information.

soundness examiners should leverage consumer compliance target examinations, work products and discussions with consumer affairs counterparts, and include a high-level supervisory conclusion. While this section is typically brief, examiners should include additional information, particularly if consumer compliance deficiencies compromise the safety and soundness of the bank or impact the adequacy of risk management. More information about the Federal Reserve's consumer compliance supervision program can be found in the [Consumer Compliance Handbook](#).

#### 1050.2.7.15 Additional Supervisory Assessments

The information technology assessment and fiduciary activities assessment should be included in this section if the examination was performed and issued under separate cover during the supervisory cycle. The summary assessments for each area should be a concise paragraph to support the assessments. The assessments of each area should be included in the text. In situations where areas require emphasis, examiners may include information on the deficiencies into the introductory comment, with more detailed comments reserved for discussion under separate subheadings, or in the applicable supplemental report page. Discussion in this section should complement previous comments made in this report without being redundant.

#### *Bank Secrecy Act/Anti Money Laundering Compliance Program*

This subsection is mandatory. This subsection should describe the outcome of the BSA and AML compliance assessment from the roll-up supervisory event. If the BSA/AML assessment was completed under separate cover, a concise paragraph should be included in this subsection describing the outcome or conclusions of the assessment. Conclusions should also be reflected in the Consolidated Management and Risk Management section of the report, as appropriate. Significant supervisory concerns should be reflected in the Supervisory Issues section.

#### *Audit Program\**

This subsection is mandatory if an audit assessment was performed during the annual supervisory cycle. If the audit assessment was not per-

formed during the supervisory cycle, examiners should comment on the bank's audit program in the Consolidated Management and Risk Management section.

#### *Other Matters\**

This subsection is optional and should only be included if matters of supervisory importance are not described elsewhere in the report. Examiners should discuss significant matters mentioned elsewhere that require further explanation, such as the type, scope, and volume of any new activity in which the organization is engaged. If issues or concerns are noted, examiners should provide comments on specific areas, such as nontraditional banking activities, affiliate relationships, and significant litigation.

#### 1050.2.7.16 Signature of Directors

This section is mandatory. If the boards of directors for the SMB and the BHC differ, examiners should include a separate signature listing of the board of directors for each entity. This section should indicate that the signature page should be attached to the report and be retained at the institution. The signature of committee members will suffice only if the committee includes outside directors and a resolution has been passed by the applicable (bank or holding company) board delegating the review to such committee.

### 1050.2.8 TIMING EXPECTATIONS FOR THE COMPLETION OF SAFETY-AND-SOUNDNESS EXAMINATION AND INSPECTION REPORTS

The Federal Reserve has established timing expectations for examination staff in completing safety-and-soundness examination and inspection reports for domestic regional financial institutions and the submission of the reports to the institutions.<sup>49</sup> These expectations apply to examination and inspection reports for domestic institutions supervised by the Federal Reserve having between \$10 billion and \$100 billion in total

49. For more information, see [SR-17-12](#), "Timing Expectations for the Completion of Safety-and-Soundness Examination and Inspection Reports for Regional Banking Organizations."

consolidated assets, including state member banks, bank holding companies, and their subsidiary Edge Act and agreement corporations, and savings and loan holding companies.

Federal Reserve supervisory staff should complete and send safety-and-soundness examination and inspection reports issued by the Federal Reserve to the institution within the following timeframes:<sup>50</sup>

- 90 calendar days from the start date for all reports issued to noncomplex holding companies;<sup>51</sup> and,
- 100 calendar days from the start date for all reports issued to state member banks, complex holding companies, and their nonbank and Edge Act subsidiaries.

In cases when reports are subject to statutory requirements for review by the Consumer Financial Protection Bureau (CFPB), Reserve Banks may add up to 30 calendar days to the above standards.<sup>52</sup> Reserve Banks may exceed the timing requirements included in this letter at the discretion of Reserve Bank senior management; however, deviations from these standards are expected to be rare, and should be appropriately documented in workpapers. At the discretion of senior Reserve Bank management, additional exemptions from these timeframe guidelines may be considered for Federal Reserve led examinations that are conducted jointly or concurrently with another insured depository institution regulator.

50. Examples of safety-and-soundness examination and inspection reports include, but are not limited to, full scope examination and inspection reports, target letters, roll-up examination and inspection letters, and specialty examination reports.

51. The start date is the date that Reserve Bank examiners and supervisory staff commence the commercial examination and inspection work, either offsite or onsite, excluding pre-exam visitations and examination preparation.

52. See sections 1022, 1024, and 1025 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. For more information on the coordination of supervisory activities with the CFPB, see also the “Memorandum of Understanding on Supervisory Coordination” attached to the June 4, 2012 joint [press release](#).

## 1060.0.1 OVERVIEW AND APPLICABILITY

Each large financial institution (LFI) is expected to ensure that the consolidated organization (or the combined U.S. operations in the case of foreign banking organizations), including its critical operations and banking offices, remain safe and sound and in compliance with laws and regulations, including those related to consumer protection.<sup>1</sup> On November 21, 2018, the Board adopted a specific rating system for LFIs in order to align with the Federal Reserve's supervisory programs and practices for these firms.<sup>2</sup> The LFI rating system provides a supervisory evaluation of whether a covered firm possesses sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions, including stressful ones.<sup>3</sup>

The LFI rating system applies to:

- bank holding companies with total consolidated assets of \$100 billion or more;
- all non-insurance, non-commercial savings and loan holding companies with total consolidated assets of \$100 billion or more;<sup>4</sup> and

1. See [SR letter 12-17/CA letter 12-14](#), "Consolidated Supervisory Framework for Large Financial Institutions." Hereinafter, when "safe and sound" or "safety and soundness" is used in this framework, related expectations apply to the consolidated organization and the firm's critical operations and banking offices. "Critical operations" are a firm's operations, including associated services, functions and support, the failure or discontinuance of which, in the view of the firm or the Federal Reserve, would pose a threat to the financial stability of the United States. "Banking offices" are defined as U.S. depository institution subsidiaries, as well as the U.S. branches and agencies of foreign banking organizations.

2. See 83 Fed. Reg. 58,724 (November 21, 2018) and 84 Fed. Reg. 4309 (February 15, 2019). The final rule is effective on February 1, 2019.

3. "Financial strength and resilience" is defined as maintaining effective capital and liquidity governance and planning processes, and sufficiency of related positions, to provide for the continuity of the consolidated organization (including its critical operations and banking offices) through a range of conditions.

"Operational strength and resilience" is defined as maintaining effective governance and controls to provide for the continuity of the consolidated organization (including its critical operations and banking offices) and to promote compliance with laws and regulations, including those related to consumer protection, through a range of conditions.

References to "financial or operational" weaknesses or deficiencies implicate a firm's financial or operational strength and resilience.

4. Savings and loan holding companies (SLHCs) are considered to be engaged in significant commercial activities if they derive 50 percent or more of their total consolidated

- U.S. intermediate holding companies of foreign banking organizations with combined U.S. assets of \$50 billion or more established pursuant to the Federal Reserve's Regulation YY.<sup>5</sup>

The Federal Reserve will assign initial LFI ratings to firms in the LISC portfolio in early 2019. For all other firms subject to the LFI rating system, the Federal Reserve will assign initial LFI ratings in early 2020.

Federal Reserve supervision staff will continue to use the RFI rating system in assessing bank holding companies with less than \$100 billion in consolidated assets. For noncomplex holding companies with less than \$3 billion in assets, Reserve Bank supervisory staff will assign only a composite RFI rating and risk-management rating to the firm following an inspection.

The LFI rating system is designed to:

- Fully align with the Federal Reserve's current supervisory programs and practices, which are based upon the LFI supervision framework's core objectives of reducing the probability of LFIs failing or experiencing material distress and reducing the risk to U.S. financial stability;
- Enhance the clarity and consistency of supervisory assessments and communications of supervisory findings and implications; and
- Provide transparency related to the supervisory consequences of a given rating.

assets or total revenues from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956, as amended (12 USC 1843(k)). SLHCs are considered to be engaged in significant insurance underwriting activities if they are either insurance companies or hold 25 percent or more of their total consolidated assets in subsidiaries that are insurance companies. SLHCs that meet these criteria are excluded from the definition of "covered savings and loan holding company" in section 217.2 of the Board's Regulation Q. See 12 CFR 217.2.

5. Total consolidated assets will be calculated based on the average of the firm's total consolidated assets in the four most recent quarters as reported on the firm's quarterly financial reports filed with the Federal Reserve. A firm will continue to be rated under the LFI rating system until it has less than \$95 billion in total consolidated assets, based on the average total consolidated assets as reported on the firm's four most recent quarterly financial reports filed with the Federal Reserve. The Federal Reserve may determine to apply the RFI rating system or another applicable rating system in certain limited circumstances.

The LFI rating system is comprised of three components:

- *Capital Planning and Positions*: an evaluation of (1) the effectiveness of a firm's governance and planning processes used to determine the amount of capital necessary to cover risks and exposures, and to support activities through a range of conditions and events; and (2) the sufficiency of a firm's capital positions to comply with applicable regulatory requirements and to support the firm's ability to continue to serve as a financial intermediary through a range of conditions.
- *Liquidity Risk Management and Positions*: an evaluation of (1) the effectiveness of a firm's governance and risk-management processes used to determine the amount of liquidity necessary to cover risks and exposures, and to support activities through a range of conditions; and (2) the sufficiency of a firm's liquidity positions to comply with applicable regulatory requirements and to support the firm's ongoing obligations through a range of conditions.
- *Governance and Controls*: an evaluation of the effectiveness of a firm's (1) board of directors,<sup>6</sup> (2) management of business lines and independent risk management and controls,<sup>7</sup> and (3) recovery planning (only for domestic firms that are subject to the Board's Large Institution Supervision Coordinating Committee (LISCC) Framework).<sup>8</sup> This rating assesses a firm's effectiveness in aligning strategic business objectives with the firm's risk appetite and risk-management capabilities; maintain-

ing effective and independent risk-management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise planning for the ongoing resiliency of the firm.<sup>9</sup>

## 1060.0.2 ASSIGNMENT OF THE LFI COMPONENT RATINGS

Each LFI component rating is assigned along a four-level scale:

- *Broadly Meets Expectations*: A firm's practices and capabilities broadly meet supervisory expectations, and the firm possesses sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions. The firm may be subject to identified supervisory issues requiring corrective action. These issues are unlikely to present a threat to the firm's ability to maintain safe-and-sound operations through a range of conditions.
- *Conditionally Meets Expectations*: Certain, material financial or operational weaknesses in a firm's practices or capabilities may place the firm's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

The Federal Reserve does not intend for a firm to be assigned a "Conditionally Meets Expectations" rating for a prolonged period, and will work with the firm to develop an appropriate timeframe to fully resolve the issues leading to the rating assignment and merit upgrade to a "Broadly Meets Expectations" rating.

A firm is assigned a "Conditionally Meets Expectations" rating-as opposed to a "Deficient" rating-when it has the ability to resolve these issues through measures that do not require a material change to the firm's business model or financial profile, or its governance, risk management or internal control structures or practices. Failure to resolve the issues in a timely manner would most likely result in the firm's downgrade to a "Deficient" rating, since the inability to resolve the issues would indicate that the firm does not

6. References to "board" or "board of directors" in this framework includes the equivalent to a board of directors, as appropriate, as well as committees of the board of directors or the equivalent thereof, as appropriate.

At this time, recovery planning expectations only apply to domestic bank holding companies subject to the Federal Reserve's LISCC supervisory framework. Should the Federal Reserve expand the scope of recovery planning expectations to encompass additional firms, this rating will reflect such expectations for the broader set of firms.

7. The evaluation of the effectiveness of management of business lines would include management of critical operations.

8. There are eight domestic firms in the LISCC portfolio: (1) Bank of America Corporation; (2) Bank of New York Mellon Corporation; (3) Citigroup, Inc.; (4) Goldman Sachs Group, Inc.; (5) JP Morgan Chase & Co.; (6) Morgan Stanley; (7) State Street Corporation; and (8) Wells Fargo & Company. In this guidance, these eight firms may collectively be referred to as "domestic LISCC firms."

9. "Risk appetite" is defined as the aggregate level and types of risk the board and senior management are willing to assume to achieve the firm's strategic business objectives, consistent with applicable capital, liquidity, and other requirements and constraints.

possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is recognized that completion and validation of remediation activities for select supervisory issues—such as those involving information technology modifications—may require an extended time horizon. In all instances, appropriate and effective risk-mitigation techniques must be utilized in the interim to maintain safe-and-sound operations under a range of conditions until remediation activities are completed, validated, and fully operational.

- *Deficient-1:* Financial or operational deficiencies in a firm’s practices or capabilities put the firm’s prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require the firm to make a material change to its business model or financial profile, or its practices or capabilities.

A firm’s failure to resolve the issues in a timely manner that gave rise to a “Conditionally Meets Expectations” rating would most likely result in its downgrade to a “Deficient” rating.

A firm with a “Deficient-1” rating is required to take timely corrective action to correct financial or operational deficiencies and to restore and maintain its safety and soundness and compliance with laws and regulations, including those related to consumer protection. There is a strong presumption that a firm with a “Deficient-1” rating will be subject to an informal or formal enforcement action, and this rating assignment could be a barrier for a firm seeking Federal Reserve approval to engage in new or expansionary activities.

- *Deficient-2:* Financial or operational deficiencies in a firm’s practices or capabilities present a threat to the firm’s safety and soundness, or have already put the firm in an unsafe and unsound condition.

A firm with a “Deficient-2” rating is required to immediately implement comprehensive corrective measures, and demonstrate the sufficiency of contingency planning in the event of further deterioration. There is a strong presumption that a firm with a “Deficient-2” rating will be subject to a formal enforcement action, and the Federal Reserve would be unlikely to approve any proposal from a firm

with this rating to engage in new or expansionary activities.

The Federal Reserve will take into account a number of individual elements of a firm’s practices, capabilities, and performance when making each component rating assignment. The weighting of an individual element in assigning a component rating will depend on its impact on the firm’s safety, soundness, and resilience as provided for in the LFI rating system definitions. For example, for purposes of the Governance and Controls rating, a limited number of significant deficiencies—or even just one significant deficiency—noted for management of a single material business line could be viewed as sufficiently important to warrant a “Deficient-1” for the Governance and Controls component rating, even if the firm meets supervisory expectations under the Governance and Controls component in all other respects.

Under the LFI rating system, a firm must be rated “Broadly Meets Expectations” or “Conditionally Meets Expectations” for each of the three component ratings (Capital, Liquidity, Governance and Controls) to be considered “well managed” in accordance with various statutes and regulations.<sup>10</sup> A “well managed” firm has sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions, including stressful ones.

### 1060.0.3 LFI RATING COMPONENTS

The LFI rating system is comprised of three component ratings: (1) capital planning and positions, (2) liquidity risk management and positions, and (3) governance and controls.<sup>11</sup>

10. 12 USC 1841 et. seq. and 12 USC 1461 et seq. See, e.g., 12 CFR 225.4(b)(6), 225.14, 225.22(a), 225.23, 225.85, and 225.86; 12 CFR 211.9(b), 211.10(a)(14), and 211.34; and 12 CFR 223.41.

11. There may be instances where deficiencies or supervisory issues may be relevant to the Federal Reserve’s assessment of more than one component area. As such, the LFI rating will reflect these deficiencies or issues within multiple rating components when necessary to provide a comprehensive supervisory assessment.

1060.0.3.1 Capital Planning and Positions Component Rating

The Capital Planning and Positions component rating evaluates (1) the effectiveness of a firm’s governance and planning processes used to determine the amount of capital necessary to cover risks and exposures, and to support activities through a range of conditions; and (2) the sufficiency of a firm’s capital positions to comply with applicable regulatory requirements and to support the firm’s ability to continue to serve as a financial intermediary through a range of conditions.

In developing this rating, the Federal Reserve evaluates:

- *Capital Planning:* The extent to which a firm maintains sound capital planning practices through effective governance and oversight; effective risk management and controls; maintenance of updated capital policies and contingency plans for addressing potential shortfalls; and incorporation of appropriately stressful conditions into capital planning and projections of capital positions; and
- *Capital Positions:* The extent to which a firm’s capital is sufficient to comply with regulatory requirements, and to support its ability to meet its obligations to depositors, creditors, and other counterparties and continue to serve as a financial intermediary through a range of conditions.

1060.0.3.1.1 Definitions for the Capital Planning and Positions Component Rating

*Broadly Meets Expectations*

A firm’s capital planning and positions broadly meet supervisory expectations and support maintenance of safe-and-sound operations. Specifically:

- The firm is capable of producing sound assessments of capital adequacy through a range of conditions; and
- The firm’s current and projected capital positions comply with regulatory requirements, and support its ability to absorb current and potential losses, to meet obligations, and to

continue to serve as a financial intermediary through a range of conditions.

A firm rated “Broadly Meets Expectations” may be subject to identified supervisory issues requiring corrective action. However, these issues are unlikely to present a threat to the firm’s ability to maintain safe-and-sound operations through a range of potentially stressful conditions.

A firm that does not meet the capital planning and position expectations associated with a “Broadly Meets Expectations” rating will be rated “Conditionally Meets Expectations,” “Deficient-1,” or “Deficient-2,” and subject to potential consequences as outlined below.

*Conditionally Meets Expectations*

Certain material financial or operational weaknesses in a firm’s capital planning or positions may place the firm’s prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

Specifically, if left unresolved, these weaknesses:

- May threaten the firm’s ability to produce sound assessments of capital adequacy through a range of conditions; and/or
- May result in the firm’s projected capital positions being insufficient to absorb potential losses, comply with regulatory requirements, and support the firm’s ability to meet current and prospective obligations and to continue to serve as a financial intermediary through a range of conditions.

The Federal Reserve does not intend for a firm to be rated “Conditionally Meets Expectations” for a prolonged period. The firm has the ability to resolve these issues through measures that do not require a material change to the firm’s business model or financial profile, or its governance, risk management, or internal control structures or practices. The Federal Reserve will work with the firm to develop an appropriate timeframe during which the firm would be required to resolve each supervisory issue leading to the “Conditionally Meets Expectations” rating.

The Federal Reserve will closely monitor the firm’s remediation and mitigation activities; in most instances, the firm will either:

1. Resolve the issues in a timely manner and, if no new material supervisory issues arise, be upgraded to a “Broadly Meets Expectations” rating because the firm’s capital planning practices and related positions would broadly meet supervisory expectations; or
2. Fail to resolve the issues in a timely manner and be downgraded to a “Deficient-1” rating, because the inability to resolve the issues would indicate that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is possible that a firm may be close to completing resolution of the supervisory issues leading to the “Conditionally Meets Expectations” rating, but new issues are identified that, taken alone, would be consistent with a “Conditionally Meets Expectations” rating. In this event, the firm may continue to be rated “Conditionally Meets Expectations,” provided the new issues do not reflect a pattern of deeper or prolonged capital planning or position weaknesses consistent with a “Deficient” rating.

A “Conditionally Meets Expectations” rating may be assigned to a firm that meets the above definition regardless of its prior rating. A firm previously rated “Deficient-1” may be upgraded to “Conditionally Meets Expectations” if the firm’s remediation and mitigation activities are sufficiently advanced so that the firm’s prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

### *Deficient-1*

Financial or operational deficiencies in a firm’s capital planning or positions put the firm’s prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm’s business model or financial profile, or its capital planning practices.

Specifically, although the firm’s current condition is not considered to be materially threatened:

- Deficiencies in the firm’s capital planning processes are not effectively mitigated. These deficiencies limit the firm’s ability to effectively

assess capital adequacy through a range of conditions; and/or

- The firm’s projected capital positions may be insufficient to absorb potential losses and to support its ability to meet current and prospective obligations and serve as a financial intermediary through a range of conditions.

Supervisory issues that place the firm’s safety and soundness at significant risk, and where resolution is likely to require steps that clearly go beyond the normal course of business—such as issues requiring a material change to the firm’s business model or financial profile, or its governance, risk management or internal control structures or practices—would generally warrant assignment of a “Deficient-1” rating.

A “Deficient-1” rating may be assigned to a firm regardless of its prior rating. A firm previously rated “Broadly Meets Expectations” may be downgraded to “Deficient-1” when supervisory issues are identified that place the firm’s prospects for maintaining safe-and-sound operations through a range of potentially stressful conditions at significant risk. A firm previously rated “Conditionally Meets Expectations” may be downgraded to “Deficient-1” when the firm’s inability to resolve supervisory issues in a timely manner indicates that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

To address these financial or operational deficiencies, the firm is required to take timely corrective action to restore and maintain its capital planning and positions consistent with supervisory expectations. There is a strong presumption that a firm rated “Deficient-1” will be subject to an informal or formal enforcement action by the Federal Reserve.

A firm rated “Deficient-1” for any rating component would not be considered “well managed,” which would subject the firm to various consequences. A “Deficient-1” rating could be a barrier for a firm seeking Federal Reserve approval of a proposal to engage in new or expansionary activities, unless the firm can demonstrate that (1) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (2) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (3) the proposed activities would not distract the firm from remediating current deficiencies or issues.

*Deficient-2*

Financial or operational deficiencies in a firm’s capital planning or positions present a threat to the firm’s safety and soundness, or have already put the firm in an unsafe and unsound condition.

Specifically, as a result of these deficiencies:

- The firm’s capital planning processes are insufficient to effectively assess the firm’s capital adequacy through a range of conditions; and/or
- The firm’s current or projected capital positions are insufficient to absorb current or potential losses, and to support the firm’s ability to meet current and prospective obligations and serve as a financial intermediary through a range of conditions.

To address these deficiencies, the firm is required to immediately (1) implement comprehensive corrective measures sufficient to restore and maintain appropriate capital planning capabilities and adequate capital positions; and (2) demonstrate the sufficiency, credibility and readiness of contingency planning in the event of further deterioration of the firm’s financial or operational strength or resiliency. There is a strong presumption that a firm rated “Deficient-2” will be subject to a formal enforcement action by the Federal Reserve.

A firm rated “Deficient-2” for any rating component would not be considered “well managed,” which would subject the firm to various consequences. The Federal Reserve would be unlikely to approve any proposal from a firm rated “Deficient-2” to engage in new or expansionary activities.

1060.0.3.2 Liquidity Risk Management and Positions Component Rating

The Liquidity Risk Management and Positions component rating evaluates (1) the effectiveness of a firm’s governance and risk-management processes used to determine the amount of liquidity necessary to cover risks and exposures, and to support activities through a range of conditions; and (2) the sufficiency of a firm’s liquidity positions to comply with applicable regulatory requirements and to support the firm’s ongoing obligations through a range of conditions.

In developing this rating, the Federal Reserve evaluates:

- *Liquidity Risk Management:* The extent to which a firm maintains sound liquidity-risk management practices through effective governance and oversight; effective risk management and controls; maintenance of updated liquidity policies and contingency plans for addressing potential shortfalls; and incorporation of appropriately stressful conditions into liquidity planning and projections of liquidity positions; and
- *Liquidity Positions:* The extent to which a firm’s liquidity is sufficient to comply with regulatory requirements, and to support its ability to meet current and prospective obligations to depositors, creditors and other counterparties through a range of conditions.

1060.0.3.2.1 Definitions for the Liquidity Risk Management and Positions Component Rating

*Broadly Meets Expectations*

A firm’s liquidity risk management and positions broadly meet supervisory expectations and support maintenance of safe-and-sound operations. Specifically:

- The firm is capable of producing sound assessments of liquidity adequacy through a range of conditions; *and*
- The firm’s current and projected liquidity positions comply with regulatory requirements, and support its ability to meet current and prospective obligations and to continue to serve as a financial intermediary through a range of conditions.

A firm rated “Broadly Meets Expectations” may be subject to identified supervisory issues requiring corrective action. However, these issues are unlikely to present a threat to the firm’s ability to maintain safe-and-sound operations through a range of potentially stressful conditions.

A firm that does not meet the liquidity risk management and position expectations associated with a “Broadly Meets Expectations” rating will be rated “Conditionally Meets Expectations,” “Deficient-1,” or “Deficient-2,” and subject to potential consequences as outlined below.

*Conditionally Meets Expectations*

Certain material financial or operational weaknesses in a firm's liquidity risk management or positions may place the firm's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

Specifically, if left unresolved, these weaknesses:

- May threaten the firm's ability to produce sound assessments of liquidity adequacy through a range of conditions; and/or
- May result in the firm's projected liquidity positions being insufficient to comply with regulatory requirements, and support its ability to meet current and prospective obligations and to continue to serve as a financial intermediary through a range of conditions.

The Federal Reserve does not intend for a firm to be rated "Conditionally Meets Expectations" for a prolonged period. The firm has the ability to resolve these issues through measures that do not require a material change to the firm's business model or financial profile, or its governance, risk management or internal control structures or practices. The Federal Reserve will work with the firm to develop an appropriate timeframe during which the firm would be required to resolve each supervisory issue leading to the "Conditionally Meets Expectations" rating.

The Federal Reserve will closely monitor the firm's remediation and mitigation activities; in most instances, the firm will either:

1. Resolve the issues in a timely manner and, if no new material supervisory issues arise, and be upgraded to a "Broadly Meets Expectations" rating because the firm's liquidity risk-management practices and related positions would broadly meet supervisory expectations; or
2. Fail to resolve the issues in a timely manner and be downgraded to a "Deficient-1" rating, because the firm's inability to resolve those issues would indicate that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is possible that a firm may be close to completing resolution of the supervisory issues leading to the "Conditionally Meets Expectations" rating, but new issues are identified that, taken alone, would be consistent with a "Condi-

tionally Meets Expectations" rating. In this event, the firm may continue to be rated "Conditionally Meets Expectations," provided the new issues do not reflect a pattern of deeper or prolonged liquidity-risk management and positions weaknesses consistent with a "Deficient" rating.

A "Conditionally Meets Expectations" rating may be assigned to a firm that meets the above definition regardless of its prior rating. A firm previously rated "Deficient-1" may be upgraded to "Conditionally Meets Expectations" if the firm's remediation and mitigation activities are sufficiently advanced so that the firm's prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

#### *Deficient-1*

Financial or operational deficiencies in a firm's liquidity risk management or positions put the firm's prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm's business model or financial profile, or its liquidity risk-management practices.

Specifically, although the firm's current condition is not considered to be materially threatened:

- Deficiencies in the firm's liquidity risk-management processes are not effectively mitigated. These deficiencies limit the firm's ability to effectively assess liquidity adequacy through a range of conditions; and/or
- The firm's projected liquidity positions may be insufficient to support its ability to meet prospective obligations and serve as a financial intermediary through a range of conditions.

Supervisory issues that place the firm's safety and soundness at significant risk, and where resolution is likely to require steps that clearly go beyond the normal course of business—such as issues requiring a material change to the firm's business model or financial profile, or its governance, risk management or internal control structures or practices—would generally warrant assignment of a "Deficient-1" rating.

A “Deficient-1” rating may be assigned to a firm regardless of its prior rating. A firm previously rated “Broadly Meets Expectations” may be downgraded to “Deficient-1” when supervisory issues are identified that place the firm’s prospects for maintaining safe-and-sound operations through a range of potentially stressful conditions at significant risk. A firm previously rated “Conditionally Meets Expectations” may be downgraded to “Deficient-1” when the firm’s inability to resolve supervisory issues in a timely manner indicates that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

To address these financial or operational deficiencies, the firm is required to take timely corrective action to restore and maintain its liquidity risk management and positions consistent with supervisory expectations. There is a strong presumption that a firm rated “Deficient-1” will be subject to an informal or formal enforcement action by the Federal Reserve.

A firm rated “Deficient-1” for any rating component would not be considered “well managed,” which would subject the firm to various consequences. A “Deficient-1” rating could be a barrier for a firm seeking Federal Reserve approval of a proposal to engage in new or expansionary activities, unless the firm can demonstrate that (1) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (2) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (3) the proposed activities would not distract the firm from remediating current deficiencies or issues.

*Deficient-2*

Financial or operational deficiencies in a firm’s liquidity risk management or positions present a threat to the firm’s safety and soundness, or have already put the firm in an unsafe and unsound condition.

Specifically, as a result of these deficiencies:

- The firm’s liquidity risk-management processes are insufficient to effectively assess the firm’s liquidity adequacy through a range of conditions; and/or
- The firm’s current or projected liquidity positions are insufficient to support the firm’s

ability to meet current and prospective obligations and serve as a financial intermediary through a range of conditions.

To address these deficiencies, the firm is required to immediately (1) implement comprehensive corrective measures sufficient to restore and maintain appropriate liquidity risk management capabilities and adequate liquidity positions; and (2) demonstrate the sufficiency, credibility and readiness of contingency planning in the event of further deterioration of the firm’s financial or operational strength or resiliency. There is a strong presumption that a firm rated “Deficient-2” will be subject to a formal enforcement action by the Federal Reserve.

A firm rated “Deficient-2” for any rating component would not be considered “well managed,” which would subject the firm to various consequences. The Federal Reserve would be unlikely to approve any proposal from a firm rated “Deficient-2” to engage in new or expansionary activities.

1060.0.3.3 Governance and Controls Component Rating

The Governance and Controls component rating evaluates the effectiveness of a firm’s (1) board of directors, (2) management of business lines and independent risk management and controls, and (3) recovery planning (for domestic LISCC firms only). This rating assesses a firm’s effectiveness in aligning strategic business objectives with the firm’s risk appetite and risk management capabilities; maintaining effective and independent risk management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise providing for the ongoing resiliency of the firm.

In developing this rating, the Federal Reserve evaluates:

- *Effectiveness of the Board of Directors:* The extent to which the board exhibits attributes that are consistent with those of effective boards in carrying out its core roles and responsibilities, including: (1) setting a clear, aligned, and consistent direction regarding the firm’s strategy and risk appetite; (2) directing senior management regarding the board’s information; (3) overseeing and holding senior management accountable, (4) supporting the independence and stature of independent risk

management and internal audit; and (5) maintaining a capable board composition and governance structure.

- *Management of Business Lines and Independent Risk Management and Controls*

The extent to which:

- Senior management effectively and prudently manages the day-to-day operations of the firm and provides for ongoing resiliency; implements the firm's strategy and risk appetite; maintains an effective risk-management framework and system of internal controls; and promotes prudent risk-taking behaviors and business practices, including compliance with laws and regulations, including those related to consumer protection.
  - Business line management executes business line activities consistent with the firm's strategy and risk appetite; identifies and manages risks; and ensures an effective system of internal controls for its operations.
  - Independent risk management effectively evaluates whether the firm's risk appetite appropriately captures material risks and is consistent with the firm's risk management capacity; establishes and monitors risk limits that are consistent with the firm's risk appetite; identifies and measures the firm's risks; and aggregates, assesses and reports on the firm's risk profile and positions. Additionally, the firm demonstrates that its internal controls are appropriate and tested for effectiveness. Finally, internal audit effectively and independently assesses the firm's risk-management framework and internal control systems, and reports findings to senior management and the firm's audit committee.
- *Recovery Planning (domestic LISCC firms only):* The extent to which recovery planning processes effectively identify options that provide a reasonable chance of a firm being able to remedy financial weakness and restore market confidence without extraordinary official sector support.

### 1060.0.3.3.1 Definitions for the Governance and Controls Component Rating

#### *Broadly Meets Expectations*

A firm's governance and controls broadly meet supervisory expectations and support maintenance of safe-and-sound operations.

Specifically, the firm's practices and capabilities are sufficient to align strategic business objectives with its risk appetite and risk-management capabilities,<sup>12</sup> maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); and otherwise provide for the firm's ongoing financial and operational resiliency through a range of conditions.

A firm rated "Broadly Meets Expectations" may be subject to identified supervisory issues requiring corrective action. However, these issues are unlikely to present a threat to the firm's ability to maintain safe-and-sound operations through a range of potentially stressful conditions.

A firm that does not meet supervisory expectations associated with a "Broadly Meets Expectations" rating will be rated "Conditionally Meets Expectations," "Deficient-1," or "Deficient-2," and subject to potential consequences, as outlined below.

#### *Conditionally Meets Expectations*

Certain material financial or operational weaknesses in a firm's governance and controls practices may place the firm's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

Specifically, if left unresolved, these weaknesses may threaten the firm's ability to align strategic business objectives with the firm's risk appetite and risk-management capabilities; maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); or otherwise provide for the firm's ongoing resiliency through a range of conditions.

The Federal Reserve does not intend for a firm to be rated "Conditionally Meets Expectations" for a prolonged period. The firm has the ability to resolve these issues through measures that do not require a material change to the

12. References to risk-management capabilities includes risk management of business lines and independent risk management and control functions, including internal audit.

firm’s business model or financial profile, or its governance, risk management or internal control structures or practices. The Federal Reserve will work with the firm to develop an appropriate timeframe during which the firm would be required to resolve each supervisory issue leading to the “Conditionally Meets Expectations” rating.

The Federal Reserve will closely monitor the firm’s remediation and mitigation activities; in most instances, the firm will either:

1. Resolve the issues in a timely manner and, if no new material supervisory issues arise, be upgraded to a “Broadly Meets Expectations” rating because the firm’s governance and controls would broadly meet supervisory expectations; or
2. Fail to resolve the issues in a timely manner and be downgraded to a “Deficient-1” rating, because the firm’s inability to resolve those issues would indicate that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is possible that a firm may be close to completing resolution of the supervisory issues leading to the “Conditionally Meets Expectations” rating, but new issues are identified that, taken alone, would be consistent with a “Conditionally Meets Expectations” rating. In this event, the firm may continue to be rated “Conditionally Meets Expectations,” provided the new issues do not reflect a pattern of deeper or prolonged governance and controls weaknesses consistent with a “Deficient” rating.

A “Conditionally Meets Expectations” rating may be assigned to a firm that meets the above definition regardless of its prior rating. A firm previously rated “Deficient” may be upgraded to “Conditionally Meets Expectations” if the firm’s remediation and mitigation activities are sufficiently advanced so that the firm’s prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

*Deficient-1*

Financial or operational deficiencies in a firm’s governance and controls put the firm’s prospects for remaining safe and sound through a

range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm’s business model or financial profile, or its governance, risk management or internal control structures or practices.

Specifically, although the firm’s current condition is not considered to be materially threatened, these deficiencies limit the firm’s ability to align strategic business objectives with its risk appetite and risk-management capabilities; maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); or otherwise provide for the firm’s ongoing resiliency through a range of conditions.

A “Deficient-1” rating may be assigned to a firm regardless of its prior rating. A firm previously rated “Broadly Meets Expectations” may be downgraded to “Deficient-1” when supervisory issues are identified that place the firm’s prospects for maintaining safe-and-sound operations through a range of potentially stressful conditions at significant risk. A firm previously rated “Conditionally Meets Expectations” may be downgraded to “Deficient-1” when the firm’s inability to resolve supervisory issues in a timely manner indicates that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

To address these financial or operational deficiencies, the firm is required to take timely corrective action to restore and maintain its governance and controls consistent with supervisory expectations. There is a strong presumption that a firm rated “Deficient-1” will be subject to an informal or formal enforcement action by the Federal Reserve.

A firm rated “Deficient-1” for any rating component would not be considered “well managed,” which would subject the firm to various consequences. A “Deficient-1” rating could be a barrier for a firm seeking Federal Reserve approval of a proposal to engage in new or expansionary activities, unless the firm can demonstrate that (1) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (2) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (3) the proposed activities would not distract the firm from remediating current deficiencies or issues.

*Deficient-2*

Financial or operational deficiencies in governance or controls present a threat to the firm's safety and soundness, or have already put the firm in an unsafe and unsound condition. Specifically, as a result of these deficiencies, the firm is unable to align strategic business objectives with its risk appetite and risk-management capabilities; maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); or otherwise provide for the firm's ongoing resiliency.

To address these deficiencies, the firm is required to immediately (1) implement comprehensive corrective measures sufficient to restore and maintain appropriate governance and control capabilities; and (2) demonstrate the sufficiency, credibility, and readiness of contingency planning in the event of further deterioration of the firm's financial or operational strength or resiliency. There is a strong presumption that a firm rated "Deficient-2" will be subject to a formal enforcement action by the Federal Reserve.

A firm rated "Deficient-2" for any rating component would not be considered "well managed," which would subject the firm to various consequences. The Federal Reserve would be unlikely to approve any proposal from a firm rated "Deficient-2" to engage in new or expansionary activities.

#### 1060.0.4 COMMUNICATION OF RATINGS

In accordance with the Federal Reserve's regulations governing confidential supervisory information, ratings assigned under the LFI rating system will be communicated by the Federal Reserve to the firm, but individual ratings are not disclosed publicly. The Federal Reserve will assign LFI ratings and communicate ratings to large firms on an annual basis and more frequently as warranted. Under the LFI rating system, the Federal Reserve will continue to rely to the fullest extent possible on the information and assessments developed by other relevant supervisors and functional regulators.

### INTRODUCTION

This section explains key capital requirements and relevant supervisory guidance that apply to firms that are subject to the large financial institutions (LFI) rating system.<sup>1</sup> The LFI rating system is used to evaluate and communicate the supervisory condition of bank holding companies (BHCs) with total consolidated assets of \$100 billion or more; all non-insurance, non-commercial savings and loan holding companies (SLHCs) with total consolidated assets of \$100 billion or more; and U.S. intermediate holding companies (IHCs) of foreign banking organizations (FBOs) with combined U.S. assets of \$50 billion or more established pursuant to the Federal Reserve's Regulation YY.

Sound capital planning for any firm begins with adherence to all applicable rules and regulations relating to capital adequacy. The following Federal Reserve regulations form the basis of the regulatory framework for assessing capital positions and capital planning:

1. Regulation YY (12 CFR part 252, subparts E and F) and Regulation LL (12 CFR part 238, subparts O and P)
2. Regulation Q (12 CFR part 217), capital adequacy requirements for Board-regulated institutions
3. Regulation Y (12 CFR 225.8) and Regulation LL (12 CFR part 238, subpart S), together known as the capital plan rule

Regulation YY and Regulation LL establish capital stress testing requirements for BHCs and covered SLHCs, respectively, with total consolidated assets of \$100 billion or more. Regulation Q establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. The capital plan rule establishes general capital planning requirements for a BHC or covered SLHC with total consolidated assets of \$100 billion or more and requires such a firm to develop an annual capital plan that is approved by its board of directors.

1. See [SR-19-3/CA 19-2](#), "Large Financial Institution (LFI) Rating System." See also 83 Fed. Reg. 58,724 (November 21, 2018) and 84 Fed. Reg. 4309 (February 15, 2019) for more information. The *Commercial Bank Examination Manual* provides more information on assessing the "capital" rating for commercial banks and thrifts as defined by the Uniform Financial Institutions Rating System. See also [SR-96-38](#).

### 1060.1.2 ENHANCED PRUDENTIAL STANDARDS: REGULATION YY (12 CFR PART 252)

The financial crisis revealed significant weaknesses in resiliency and risk management in the financial sector, and demonstrated how the failure or distress of large, leveraged, and interconnected financial companies, including FBOs, could pose a threat to U.S. financial stability. To address weaknesses in the banking sector that were evident in the financial crisis, the Board strengthened prudential standards for large U.S. and foreign banking organizations. These enhanced standards included capital planning requirements; supervisory and company-run stress testing; liquidity risk management, stress testing, and buffer requirements; and single counterparty credit limits. The Board's enhanced standards also implemented section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which directed the Board to establish enhanced prudential standards for BHCs and FBOs with total consolidated assets of \$50 billion or more.<sup>2</sup>

For FBOs, the Board enhanced standards were based, in part, on the size and complexity of an FBO's activities in the United States. The standards applicable to FBOs with a more limited U.S. presence largely rely on compliance with comparable home country standards applied at the consolidated foreign parent level. In comparison, an FBO with a significant U.S. presence is subject to enhanced prudential standards and supervisory expectations that generally apply to its combined U.S. operations.<sup>3</sup>

The Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) amended section 165 of the Dodd-Frank Act by raising the threshold for general application of enhanced prudential standards.<sup>4</sup> More specifically, EGRRCPA increased the \$50 billion minimum total consolidated asset threshold to

2. 12 U.S.C. 5365.

3. "Combined U.S. operations" of an FBO means the U.S. branches and agencies of the FBO, if any, and the U.S. subsidiaries of the FBO, if any (such as a U.S. IHC and subsidiaries of such U.S. subsidiaries). The combined U.S. operations of an FBO does not include any section 2(h)(2) company, as defined in section 2(h)(2) of the Bank Holding Company Act (12 U.S.C. 1841(h)(2)). For more information on "combined U.S. operations," see 12 CFR 252.2 and the FR-Y-15 report instructions.

4. Public Law 115-174, 132 Stat. 1296 (2018).

Table 1. Categories of regulatory capital and liquidity requirements in Regulation YY

Category	U.S. banking organizations and foreign banking organizations <sup>1</sup>
I	U.S. GSIBs and their depository institution subsidiaries <sup>2</sup>
II	\$700 billion or more in total consolidated assets; or \$75 billion or more in cross-jurisdictional activity; do not meet the criteria for Category I. <sup>3</sup>
III	\$250 billion or more in assets, or firms with \$100 billion or more in assets and at least \$75 billion in (1) nonbank assets, (2) weighted short-term wholesale funding, or (3) off-balance-sheet exposure, that are not subject to Category I or II standards.
IV	\$100 billion or more in total consolidated assets; do not meet the criteria for Category I, II or III.

<sup>1</sup> For **U.S. banking organizations**, the applicable category of regulatory capital and liquidity requirements is measured at the level of the top-tier banking organization level, and applies to any of its depository institution subsidiaries for purposes of capital requirements or to any of its depository institution subsidiaries with \$10 billion or more in total consolidated assets for liquidity requirements.

For **FBOs**, the applicable category of regulatory capital and liquidity requirements is measured at the level of the top-tier U.S. IHC level, and applies to any depository institution subsidiary of such holding company for purposes of capital requirements or to any depository institution subsidiary with \$10 billion or more in total consolidated assets for liquidity requirements.

<sup>2</sup> Category I standards apply solely to U.S. banking organizations.

<sup>3</sup> Cross jurisdictional activity is equal to the sum of cross jurisdictional claims and cross jurisdictional liabilities, as reported in the FR Y-15, “Systemic Risk Report.”

\$250 billion for general application of enhanced prudential standards to BHCs. EGRRCPA also provides the Board with discretion to apply standards to BHCs with total consolidated assets of between \$100 billion and \$250 billion.

In connection with its implementation of EGRRCPA and part of the Board’s periodic efforts to improve the transparency, efficiency, and risk-sensitivity of its regulations, the Board revised Regulation YY by establishing categories of prudential standards applicable to BHCs, SLHCs that are not substantially engaged in insurance underwriting or commercial activities (covered SLHCs), and FBOs to align those requirements with a firm’s risk profile and to apply consistent standards across similarly situated firms.<sup>5</sup> In particular, the regulation includes risk-based indicators to differentiate firms and tailor the application of enhanced prudential standards based on their (1) size, (2) cross-jurisdictional activity, (3) reliance on short-term wholesale funding, (4) nonbank assets, (5) off-

balance-sheet exposure, and (6) whether a firm is identified as a U.S. GSIB under the Board’s rules.<sup>6</sup> Each of the risk-based indicators is designed to identify, in a transparent way, firms that pose heightened risk. For example, material reliance on unstable short-term wholesale funding could lead to funding runs that can place stress on a firm and result in dislocations in asset markets should a firm liquidate assets at fire sale prices to recover its funding needs. Table 1 summarizes the scoping criteria for categories of regulatory capital and liquidity requirements in Regulation YY.

1060.1.2.1 Company Run Stress Testing Requirements

Stress testing is a core element of the Board’s regulatory framework and supervisory program for large firms. Stress testing enables the Board to assess whether large firms have sufficient capital to absorb potential losses and continue lending under severely adverse conditions. Regulation YY (12 CFR part 252, subpart F) establishes the requirement for certain firms to conduct stress tests. The company-run stress testing

5. Other than risk-committee and related risk-management requirements, the final rule eliminated enhanced regulatory requirements for banking organizations with less than \$100 billion in total assets. For FBOs with a limited U.S. presence, the final rule raised the global asset thresholds consistent with the changes made by EGRRCPA and continues to rely on compliance with comparable home-country standards.

6. For FBOs, Regulation YY measures risk-based indicators of the combined U.S. operations or U.S. IHC, as applicable. For U.S. banking organizations, Regulation YY measures risk-based indicators of the total consolidated organization.

Table 2. Applicability of company run stress tests

Type of covered company	Frequency of required stress test
Global systemically important BHC	Annually, by April 5 of each calendar year based on data as of December 31 of the preceding calendar year, unless the time or the as-of date is extended by the Board in writing.
Category II BHC or U.S. IHC	Annually, by April 5 of each calendar year based on data as of December 31 of the preceding calendar year, unless the time or the as-of date is extended by the Board in writing.
Category III BHC or U.S. IHC	Biennially, by April 5 of each calendar year ending in an even number, based on data as of December 31 of the preceding calendar year, unless the time or the as-of date is extended by the Board in writing.
Nonbank financial company supervised by the Board	Periodically, as determined by rule or order.

requirements apply to Category I, Category II, and Category III U.S. BHCs, covered SLHCs, and IHCs. See table 2 for more information on the applicability of the company-run stress tests.

The company run stress testing requirements also apply to insured depository institutions with greater than \$250 billion in average total consolidated assets over the prior four quarters (12 CFR part 252, subpart B).

Regulation YY also establishes definitions of stress testing, related terms, as well as methodologies for conducting stress tests, and reporting and disclosure requirements for covered companies.<sup>7</sup> In conducting a stress test under Regulation YY, for each quarter of the planning horizon, a covered company must estimate the following for each scenario required to be used:

1. Losses, pre-provision net revenue, provision for credit losses, and net income
2. The potential impact on the regulatory capital levels and ratios applicable to the covered bank, and any other capital ratios specified by the Board, incorporating the effects of any capital action over the planning horizon and maintenance of an allowance for loan losses or adjusted allowance for credit losses, as appropriate, for credit exposures throughout the planning horizon

The company-run stress testing requirements in Regulation YY also describe the assumptions covered companies must consider regarding its capital actions over the planning horizon. Specifically, it is assumed that the covered company will

1. not pay any dividends on any instruments that qualify as common equity tier 1 capital;
2. make payments on instruments that qualify as additional tier 1 capital or tier 2 capital equal to the stated dividend, interest, or principal due on such instrument;
3. not make a redemption or repurchase of any capital instrument that is eligible for inclusion in the numerator of a regulatory capital ratio; and
4. not make any issuances of common stock or preferred stock.

1060.1.2.1.1 Board and Senior Management Responsibilities

The board of directors or appropriate board committee must review and approve the policies and procedures of the stress testing processes as frequently as economic conditions or the condition of the covered company may warrant. At a minimum, the board of directors must review and approve its stress testing policies and procedures each year a stress test is conducted.<sup>8</sup>

Senior management must establish and maintain a system of controls, oversight, and documentation, including policies and procedures, that are designed to ensure that its stress testing processes are effective in meeting the requirements in Regulation YY. These policies and procedures must, at a minimum, describe the covered company’s stress testing practices and methodologies, and processes for validating and updating the company’s stress test practices and

8. 12 CFR 252.56(c)(2).

7. See 12 CFR 252.56.

methodologies consistent with applicable laws and regulations.<sup>9</sup>

The board of directors and senior management must receive a summary of the results of any stress test conducted under Regulation YY. After completing the stress tests, the board of directors and senior management must consider the stress test results

- as part of the covered company’s capital plan and capital planning process, including when making changes to the covered company’s capital structure (including the level and composition of capital);
- when assessing the covered company’s exposures, concentrations, and risk positions; and
- in the development or implementation of any plans of the covered company for recovery or resolution.

1060.1.3 REGULATION Q (12 CFR PART 217): CAPITAL POSITIONS

In 2013, the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively, the agencies) adopted a rule replacing their general risk-based capital requirements, advanced approaches capital requirements, market risk capital requirements, and leverage capital requirements.<sup>10</sup> The Federal Reserve’s capital rule, Regulation Q, addresses weaknesses highlighted during the 2008–09 financial crisis by helping to ensure that the banking system is better able to absorb losses and continue to lend in future periods of economic stress. In addition, Regulation Q implements certain federal laws related to capital requirements and international regulatory capital standards adopted by the Basel Committee on Banking Supervision.

1060.1.3.1 APPLICABILITY

Regulation Q applies on a consolidated basis to every Board-regulated institution (referred to as a “banking organization”) that is

- a state member bank;

- a BHC domiciled in the United States that is not subject to 12 CFR part 225, appendix C, or
- a covered SLHC domiciled in the United States.

Regulation Q does not apply to SLHCs substantially engaged in insurance underwriting or commercial activities, or to SLHCs that are insurance underwriting companies.

*Smaller Firms that are not Fully Subject to Regulation Q*

The Board may, by order, apply any or all of Regulation Q to any BHC, based on an institution’s asset size, level of complexity, risk profile, scope of operations, or financial condition. However, there are certain smaller firms that are generally not subject to Regulation Q. As noted above, Regulation Q does not apply to holding companies that are subject to 12 CFR part 225, appendix C, which is the “Small Bank Holding Company and Savings and Loan Holding Company Policy Statement.” The Small Bank Holding Company and Savings and Loan Holding Company Policy Statement applies to BHCs with pro forma consolidated assets of less than \$3 billion that

1. are not engaged in significant nonbanking activities either directly or through a non-bank subsidiary;
2. do not conduct significant off-balance-sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; and
3. do not have a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission.

The Board may, in its discretion, exclude any BHC, regardless of asset size, from the policy statement if such action is warranted for supervisory purposes. With some exceptions, the policy statement applies to SLHCs as if they were BHCs.<sup>11</sup>

In 2019, the agencies adopted a final rule that provides for a simple measure of capital adequacy for certain community banking organizations, consistent with section 201 of

9. 12 CFR 252.56(c)(1)  
10. See 12 CFR part 217 (Regulation Q).

11. See “Control and Ownership (BHC Formations),” in this manual for more information on the Small Bank Holding Company and Savings and Loan Holding Company Policy Statement.

Table 3. Captial Ratio Calculations and Minimum Ratios

Ratio	Calculation	Minimum
Common equity tier 1 capital ratio	$\frac{\text{common equity tier 1 capital}}{\text{standardized total risk-weighted assets}}$	4.5%
Tier 1 capital ratio	$\frac{\text{tier 1 capital}}{\text{standardized total risk-weighted assets}}$	6%
Total capital ratio	$\frac{\text{total capital}}{\text{standardized total risk-weighted assets}}$	8%
Leverage ratio	$\frac{\text{tier 1 capital}}{\text{average total consolidated assets}}$	4%

EGRRCPA.<sup>12</sup> This final rule established the community bank leverage ratio (CBLR) framework, which provides an optional measure of capital adequacy for depository institutions and depository institution holding companies with certain characteristics. A qualifying banking organization that elects to use the CBLR framework and that maintains a leverage ratio of greater than 9 percent will be considered to have satisfied the generally applicable risk-based and leverage capital requirements in the agencies’ capital rules.

1060.1.3.2 Minimum Capital Ratios

All banking organizations covered under Regulation Q (12 CFR part 217) are subject to the following minimum regulatory capital requirements: a common equity tier 1 capital ratio of 4.5 percent, a tier 1 capital ratio of 6 percent, a total capital ratio of 8 percent of risk-weighted assets, and a leverage ratio of 4 percent.<sup>13</sup> See table 3 for more information on the calculation of these ratios.

Most banking organizations are expected to operate with capital levels above the minimum ratios. In addition, banking organizations that are undertaking significant expansion or that are exposed to high or unusual levels of risk are expected to maintain capital well above the

minimum ratios; in such cases, the Federal Reserve may specify a higher minimum requirement.

In implementing Regulation Q, the Federal Reserve has reserved the authority to require a banking organization to hold more capital if the minimum requirements are not commensurate with the bank’s credit, market, operational, or other risks (see 12 CFR 217.1(d)). This is a formal process that requires Federal Reserve approval, and an examiner alone cannot provide this directive.

The *Commercial Bank Examination Manual’s* section entitled, “Assessment of Capital Adequacy” contains more information on the components of capital and risk weighted assets, as defined in Regulation Q.

1060.1.3.3 Supplementary Leverage Ratio

The supplementary leverage ratio measures tier 1 capital relative to total leverage exposure, which includes on-balance-sheet assets (including deposits at central banks) and certain off-balance-sheet exposures.<sup>14</sup>

Advanced approaches banking organizations and Category III banking organizations (both of which are described in greater detail below) are subject to a minimum supplementary leverage ratio of 3 percent. Relative to the tier 1 leverage ratio, the denominator of the supplementary leverage ratio incorporates certain off-balance-

12. See 84 Fed. Reg. 61,797 (November 13, 2019) and 12 CFR 217.12.

13. Tier 1 capital is equal to the sum of common equity tier 1 capital and additional tier 1 capital. Total capital is the sum of common equity tier 1, additional tier 1, and tier 2 capital.

14. 12 CFR 217.10(a)(5) and (c)(4)

sheet exposures such as commitments and derivative exposures. The Federal Reserve applies this to advanced approaches banking organizations regulated by the Board and Category III Board-regulated institutions, because these firms typically hold higher levels of off-balance-sheet exposure that are not captured by the leverage ratio. The supplementary leverage ratio also factors into the prompt corrective action capital framework applicable to these banking organizations at the depository institution level.

In January 2020, the Federal Reserve, together with the OCC and FDIC, issued a final rule to implement EGRRCPA section 402.<sup>15</sup> Under EGRRCPA section 402, the supplementary leverage ratio must not take into account funds of a custodial bank that are deposited with certain central banks, provided that any amount that exceeds the value of deposits of the custodial bank that are linked to fiduciary or custodial and safekeeping accounts must be taken into account when calculating the supplementary leverage ratio as applied to the custodial bank. Custody, safekeeping, and asset servicing activities generally involve holding securities or other assets on behalf of clients, as well as activities such as transaction settlement, income processing, and related record keeping and operational services. To qualify as a custodial banking organization, a depository institution holding company must have a ratio of assets under custody-to-total assets of at least 30:1, calculated as an average over the prior four calendar quarters.

1060.1.3.4 Enhanced Supplementary Leverage Ratio

In 2015, the Federal Reserve implemented an enhanced supplemental leverage ratio requirement for U.S. GSIBs and their depository institution subsidiaries.<sup>16</sup> The enhanced supplementary ratio standards require each U.S. GSIB to maintain a supplementary leverage ratio above 5 percent to avoid limitations on the firm’s distributions and certain discretionary bonus payments and also require each of its insured depository institutions to maintain a supplementary leverage ratio of at least 6 percent to be deemed “well capitalized” under the prompt corrective action framework of each agency. Banking organizations that do not meet the enhanced supple-

mentary leverage ratio are subject to restrictions on dividends and discretionary bonus payments, similar to the approach used for purposes of the countercyclical capital buffer (CCyB) described below.

1060.1.3.5 Countercyclical Capital Buffer

The CCyB is a supplemental policy tool that the Federal Reserve can increase during periods of rising vulnerabilities in the financial system and reduce when vulnerabilities recede. It is designed to increase the resilience of advanced approaches banking organizations or Category III Board-regulated institutions when there is an elevated risk of above-normal losses. Increasing the resilience of such organizations will, in turn, improve the resilience of the broader financial system. The Federal Reserve would most likely begin to increase the CCyB above 0 percent to augment minimum capital requirements and other capital buffers when systemic vulnerabilities are meaningfully above normal. By requiring large banking organizations to hold additional capital during a period of excess and removing the requirement to hold additional capital when the vulnerabilities have diminished, the CCyB is expected to moderate fluctuations in the supply of credit over time.

A CCyB, if applicable, would expand the capital conservation buffer by up to 2.5 percent of a banking organization’s total risk-weighted assets for advanced approaches banking organizations or Category III Board-regulated institutions. The amount of the CCyB amount is determined by a country’s bank supervisor and will differ by jurisdiction. At any point in time, a country’s bank supervisor determines the degree of excessive credit growth in its jurisdictions. An advanced approaches Board-regulated institution or a Category III Board-regulated institution must calculate a CCyB amount in accordance with Regulation Q (12 CFR 217.11(b)) for purposes of determining its maximum payout ratio. The payout ratio is set forth in Regulation Q as well as the *Commercial Bank Examination Manual’s* section entitled “Dividends.”

1060.1.3.6 GSIB Surcharge Requirement

In July 2015, the Board adopted the GSIB surcharge requirements (12 CFR part 217, subpart H) as part of its implementation of sec-

15. 85 Fed. Reg. 4569 (January 27, 2020).  
16. 80 Fed. Reg. 49,082 (August 14, 2015).

tion 165 of the Dodd-Frank Act.<sup>17</sup> The GSIB surcharge requirement works to mitigate the potential risk that the material financial distress or failure of a GSIB could pose to U.S. financial stability by increasing the stringency of capital standards for GSIBs as they grow across a group of metrics that serve as proxies for their systemic risk profile. The GSIB surcharge requirements establish a methodology to identify whether a U.S. top-tier BHC is a GSIB and imposes a risk-based capital surcharge on such an institution. The GSIB surcharge requirements takes into consideration the nature, scope, size, scale, concentration, interconnectedness, and mix of activities of each company subject to the rule in its methodology for determining whether the company is a GSIB and the size of the surcharge. These factors are captured in the method 1 and method 2 scores, which use quantitative metrics reported on the FR Y-15 reporting form to measure a firm's systemic footprint. The GSIB surcharge requirements establish the criteria for identifying a GSIB and the methods that those firms must use to calculate a risk-based capital surcharge, which is calibrated to each firm's overall systemic risk and which expands the capital conservation buffer requirement for these firms.

#### 1060.1.3.7 Advanced Approaches

The advanced approaches framework provides a risk-based capital framework that permit certain banking organizations to use an internal risk-measurement approach to calculate capital requirements and advanced measurement approaches in order to calculate regulatory credit and operational-risk capital requirements. An advanced approaches banking organization must calculate its risk-based capital ratios using both the standardized and advanced approaches and meet each minimum requirement with the lower of the two ratios. The advanced approaches are supplemented by the market risk-capital requirement.

The advanced approaches in Regulation Q (12 CFR part 217) apply to Category I and Category II banking organizations. The advanced approaches also apply to a state member bank that is a subsidiary of a global systemically important BHC, a Category II Board-regulated institution; or a subsidiary of a bank, BHC, or SLHC that uses the advanced approaches to calculate its risk-based capital requirements. Advanced approaches banking organizations also

include those banking organizations that have elected to use the advanced approaches to calculate their total risk-weighted assets.

#### 1060.1.3.8 Market Risk Capital Requirement

Banking organizations with significant trading activities are subject to regulatory capital requirements for market risk. The purpose of the market risk capital requirement is to establish risk-based capital requirements for Board-regulated institutions with significant exposure to market risk, provide methods for these Board-regulated institutions to calculate their standardized measure for market risk and, if applicable, advanced measure for market risk, and establish public disclosure requirements. The market risk capital requirement applies to any Board-regulated institution with aggregate trading assets and trading liabilities equal to 10 percent or more of total assets or \$1 billion or more. On a case-by-case basis, the Federal Reserve may require an institution that does not meet these criteria to comply with the market risk capital requirement if deemed necessary for safety-and-soundness reasons. Table 4 summarizes the applicability of several requirements in Regulation Q.

### 1060.1.4 REGULATION Y (12 CFR PART 225): CAPITAL PLAN RULE AND STRESS CAPITAL BUFFER

#### 1060.1.4.1 Background and Interconnections with other Capital Rules

The firm's planned capital actions should be consistent with the firm's capital policy, including the amounts of planned dividends and repurchases. A firm's processes for managing and allocating its capital resources are critical to its financial strength and resiliency and to the stability and effective functioning of the U.S. financial system. In 2011, the Board implemented its capital plan rule to require large firms to develop and maintain capital plans supported by robust processes for assessing their capital adequacy.<sup>18</sup>

18. See 12 CFR 225.8; see also Capital Plans, 76 Fed. Reg. 74,631 (December 1, 2011). Amendments to the capital plan rule are found in 79 Fed. Reg. 64,040 (October 27, 2014); 80 Fed. Reg. 75,424 (December 2, 2015); 85 Fed. Reg. 15,576 (March 18, 2020); and 86 Fed. Reg. 7927 (February 3, 2021).

17. 80 Fed. Reg. 49,082 (August 14, 2015)

Table 4. Applicability of key requirements of Regulation Q

Requirement in Regulation Q (12 CFR part 217)	Category I	Category II	Category III	Category IV
Supplementary leverage ratio	Yes	Yes	Yes	
Enhanced supplementary leverage ratio	Yes			
Countercyclical capital buffer	Yes	Yes	Yes	
Must recognize elements of accumulated other comprehensive income (AOCI) in regulatory capital	Yes	Yes		
GSIB surcharge requirement	Yes			
Advanced approaches	Yes	Yes		
Market risk capital requirement <sup>1</sup>	Yes	Yes	Depends on the firm's activities	Depends on the firm's activities
Minimum capital standardized capital requirements and leverage ratio (12 CFR 217.10)	Yes	Yes	Yes	Yes

<sup>1</sup> Any Board-regulated institution with aggregate trading assets and trading liabilities equal to 10 percent or more of total assets or \$1 billion or more.

The aim of these requirements is to ensure that large firms have robust, forward-looking capital planning processes that account for their unique risks, and to help ensure that large firms have sufficient capital to continue operations throughout times of economic and financial stress. The capital plan rule works in conjunction with the stress test rules adopted by the Board to implement the stress testing requirements of the Dodd-Frank Act.<sup>19</sup>

In March 2020, the Board adopted the stress capital buffer rule to integrate its capital plan rule and regulatory capital rule through the establishment of a stress capital buffer requirement, creating a single, risk-sensitive frame-

work for large banking organizations.<sup>20</sup> To achieve individually tailored and risk-sensitive capital requirements for firms subject to the capital plan rule, the stress capital buffer rule establishes the size of a firm's stress capital buffer requirement based in part on a supervisory stress test conducted by the Federal Reserve. Through the integration of the capital rule and Comprehensive Capital Analysis and Review (CCAR), the final rule removed redundant elements of the capital and stress testing frameworks, including the CCAR quantitative objection and the assumption that a firm makes all capital actions under stress.

In October 2019, the Board issued a final rule that established a revised framework for applying prudential standards to large firms to align

19. See 12 U.S.C. 5365(i) and 12 CFR part 252.

20. See Regulations Q, Y, and YY: Regulatory Capital, Capital Plan, and Stress Test Rules, 85 Fed. Reg. 15,576 (March 18, 2020).

prudential standards more closely to a large firm's risk profile (tailoring rule).<sup>21</sup> The tailoring rule established four categories of prudential standards and applies them based on indicators designed to measure the risk profile of a firm.<sup>22</sup> The scoping criteria for categories of prudential standards in the tailoring rule are described above in table 1. In February 2021, the Board issued a final rule to tailor the requirements in the Board's capital plan rule based on risk. Among other things, the February 2021 final rule modified the capital planning, regulatory reporting, and stress capital buffer requirements for firms subject to Category IV standards under the tailoring rule.<sup>23</sup>

#### 1060.1.4.2 Capital Plan Requirements and Applicability

The capital plan rule applies to top-tier U.S. BHCs and top tier U.S. SLHCs with average total consolidated assets of \$100 billion or more, as well as IHCs pursuant to the Board's Regulation YY.<sup>24</sup> The capital plan rule requires such firms to develop and maintain a capital plan that includes an assessment of the sources and uses of capital and reflects forward-looking projections of revenue and losses to monitor and maintain their internal capital adequacy.

At least annually, and prior to the submission of the capital plan to the Federal Reserve, a large firm's board of directors or a designated committee thereof is required to review the capital plan.<sup>25</sup> The board of directors or designated committee must (1) review the robustness of the holding company's process for assessing capital adequacy, (2) ensure that any deficiencies in the firm's process for assessing capital adequacy are appropriately remedied, and (3) approve the firm's capital plan.<sup>26</sup>

#### 1060.1.4.3 Mandatory Elements of a Capital Plan

A capital plan is defined as a written presentation of a large firm's capital planning strategies and capital adequacy process that includes certain mandatory elements. These mandatory elements are organized into four main components. For more information on the subcomponent elements of these four main components, see Regulation Y and Regulation LL.

1. An assessment of the expected uses and sources of capital over the planning horizon (at least nine quarters, beginning with the quarter preceding the quarter in which the firm submits its capital plan) that reflects the firm's size, complexity, risk profile, and scope of operations, assuming both expected and stressful conditions.
2. A detailed description of the firm's process for assessing capital adequacy, including how the firm will, under expected and stressful conditions,
  - maintain capital commensurate with its risks;
  - maintain capital above the minimum regulatory capital ratios;
  - serve as a source of strength to its subsidiary depository institutions; and
  - maintain sufficient capital to continue its operations by maintaining ready access to funding, meeting its obligations to creditors and other counterparties, and continuing to serve as a credit intermediary.
3. The firm's capital policy, which is the firm's written assessment of the principles and guidelines used for capital planning, capital issuance, usage and distributions, including internal capital goals, the quantitative or qualitative guidelines for dividend and stock repurchases, the strategies for addressing potential capital shortfalls, and the internal governance procedures around capital policy principles and guidelines; and
4. A discussion of any expected changes to the firm's business plan that are likely to have a material impact on the firm's capital adequacy or liquidity. For example, the capital plan should reflect any expected material effects of new lines of business or activities on the firm's capital adequacy or liquidity, including revenue and losses.

21. See Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations, 84 Fed. Reg. 59,032 (November 1, 2019).

22. The final rule increased the threshold for general application of these standards from \$50 billion to \$100 billion in total consolidated assets.

23. 86 Fed. Reg. 7927 (February 3, 2021).

24. The capital plan rule also applies to nonbank financial companies supervised by the Board that is made subject to a rule or order of the Board.

25. The capital plans must be submitted by April 5th of a calendar year (or other Federal Reserve Board designated date) for review.

26. As part of this review, the board of directors should consider any remaining uncertainties, limitations, and assumptions associated with the firm's capital adequacy process.

The Board, or the appropriate Reserve Bank with concurrence of the Board, will consider the following factors in reviewing a firm’s capital plan:

- the comprehensiveness of the capital plan, including the extent to which the analysis underlying the capital plan captures and addresses potential risks stemming from activities across the firm and the firm’s capital policy;
- the reasonableness of the firm’s capital plan, the assumptions and analysis underlying the capital plan, and the robustness of its capital adequacy process;
- relevant supervisory information about the firm and its subsidiaries;
- the firm’s regulatory and financial reports, as well as supporting data that would allow for an analysis of the firm’s loss, revenue, and reserve projections;
- the results of any stress tests conducted by the firm or the Federal Reserve; and
- other information requested or required by the Board or the appropriate Reserve Bank, as well as any other information relevant, or related, to the firm’s capital adequacy.

1060.1.4.4 The Capital Plan Rule and Firms Subject to Category IV Standards

All banking organizations, regardless of size and complexity, are expected to have the capacity to analyze the potential impact of adverse outcomes on their financial condition, including on capital.<sup>27</sup> Therefore, risk-management prac-

tices should be tailored to the risk and complexity of the individual firm and should include practices to identify and assess its sensitivity to unexpected adverse outcomes before they occur.

In February 2021, the Board issued a final rule that removed the requirement for firms subject to Category IV standards to include certain elements in their capital plans.<sup>28</sup> Firms subject to Category IV standards are not required to calculate estimates of projected revenues, losses, reserves, or pro forma capital levels (effectively a form of stress testing) using scenarios provided by the Board. However, under certain circumstances, based on the macroeconomic outlook or based on the firm’s risk profile, financial condition, or corporate structure, the Board may require a firm subject to Category IV standards to submit a capital plan under scenarios provided by the Board. Firms subject to Category IV standards are still required to provide a forward-looking analysis of income and capital levels under expected and stressful conditions in their annual capital plans. These projections are required to be tailored to, and sufficiently capture, the firm’s exposures, activities, and idiosyncratic risks in their capital plans. The Federal Reserve conducts an annual assessment of the capital plan of a firm subject to Category IV standards as part of its ongoing supervisory process, and the results of this assessment will continue to be an input into the firm’s capital planning and positions component of the LFI rating system.

1060.1.4.5 Stress Capital Buffer

During the 2008–09 financial crisis, some banking organizations continued to pay dividends and substantial discretionary bonuses even as their financial condition weakened. Such capital distributions had a significant negative impact on the overall strength of the banking sector. To encourage better capital conservation and to enhance the resilience of the banking system, Regulation Q limits capital distributions and discretionary bonus payments for banking organizations that do not hold a specified amount of common equity tier 1 capital in addition to the amount of regulatory capital necessary to meet the minimum risk-based capital requirements (capital conservation buffer).

27. For example, smaller BHCs are subject to guidance that clarifies such firms are expected to hold capital commensurate with their overall risk profile. See [SR-09-4](#), Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies (February 24, 2009, revised July 24, 2020). Holding companies with less than \$100 billion in total consolidated assets are subject to an overall evaluation and rating of managerial and financial condition and an assessment of future potential risk to subsidiary depository institution(s) as part of the RFI or Modified RFI rating. See [SR-19-4/CA-19-3](#), Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than \$100 billion (February 26, 2019) and [SR-13-21](#), Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of \$10 Billion or Less (December 17, 2019, revised March 6, 2019). BHCs with total consolidated assets of \$100 billion or greater and certain SLHCs are subject to a supervisory evaluation of whether a covered firm possesses sufficient financial and operational strength and resilience to

maintain safe-and-sound operations through a range of conditions, including stressful ones. See [SR-19-3/CA-19-2](#), “Large Financial Institution (LFI) Rating System” (February 26, 2019).

28. 86 Fed. Reg. 7927 (February 3, 2021).

On March 4, 2020, the Board adopted a final rule establishing a stress capital buffer for BHCs and U.S. IHCs of FBOs that have \$100 billion or more in total consolidated assets. The stress capital buffer rule integrates the Federal Reserve's stress test results with its non-stress capital requirements.<sup>29</sup> More specifically, the stress capital buffer rule integrates CCAR with the capital rule. Under the stress capital buffer requirement, the Federal Reserve uses the results of its supervisory stress test to establish the size of a firm's stress capital buffer requirement, which replaces the static 2.5 percent of the risk-weighted assets component of a firm's capital conservation buffer requirement.

The stress capital buffer rule included several changes to the assumptions embedded in the supervisory stress test, notably removing the assumption that firms make all planned common distributions and excluding material business plan changes from the stress capital buffer requirement calculation. Previously, under CCAR, the Board assumed that a firm would continue to make all planned dividends and share repurchases under stress, and therefore required firms to pre-fund nine quarters of planned dividends and share repurchases. Under the stress capital buffer rule, the Board no longer assumes that a firm would continue to make all planned dividends and share repurchases under stress. The stress capital buffer requirement includes four-quarters of planned dividends; therefore, firms are subject to a pre-funding requirement of four quarters of planned dividends. This approach recognizes the capital rule's automatic limitations on capital distributions while continuing to promote forward-looking capital planning and mitigate pro-cyclicality.

A firm's stress capital buffer requirement varies based on a firm's risk. A firm that does not maintain capital ratios above its minimums plus its buffer requirements faces restrictions on its capital distributions and discretionary bonus payments. As explained in Regulation Y, the Board will notify a firm of its stress capital buffer requirement and an explanation of the results of the supervisory stress test by June 30 of the calendar year in which the capital plan was submitted or within 90 calendar days of receiving notice that the Board will recalculate the firm's stress capital buffer requirement pursuant to Regulation Y.<sup>30</sup>

#### *1060.1.4.5.1 Calculation and Timing of Stress Capital Buffer Requirements for Firms Subject to Category IV Standards*

The tailoring rule made two changes to the stress testing rules for firms subject to Category IV standards. First, the tailoring rule removed the requirement for firms subject to Category IV standards to conduct and publicly disclose the results of company-run stress tests as defined in the Board's stress testing rules. Second, the tailoring rule changed the frequency of the supervisory stress test for firms subject to Category IV standards from annual to biennial.

The Board issued a final rule in February 2021, requiring a firm subject to Category IV standards to update the stress test portion of the stress capital buffer requirement in a manner consistent with the frequency of the supervisory stress test (that is, both would occur every other year).<sup>31</sup> The stress test portion of such a Category IV firm's stress capital buffer requirement is not updated in a year in which it does not participate in the supervisory stress test. A Category IV firm may elect to opt-in to a stress test in a year in which the firm would not generally be subject to the supervisory stress test and to receive an updated stress capital buffer requirement in that year.

### 1060.1.5 SUPERVISORY ACTIVITIES, GUIDANCE, AND OTHER CONSIDERATIONS IN ASSESSING CAPITAL

#### 1060.1.5.1 Supervisory Stress Test Requirements

Regulation YY requires the Federal Reserve to conduct annual analyses of nonbank financial companies supervised by the Board and BHCs with \$100 billion or more in total consolidated assets to evaluate whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions. The stress test requirements in Regulation YY establish a framework to conduct supervisory stress tests of large BHCs.

31. 86 Fed. Reg. 7927 (February 3, 2021).

29. 85 Fed. Reg. 15,576 (March 18, 2020).  
30. 12 CFR 225.8(h).

1060.1.5.1.1 *Stress Testing Analysis Conducted by the Federal Reserve*

For the supervisory stress tests described in Regulation YY, the Board conducts an analysis of each covered company’s capital, on a total consolidated basis, taking into account all relevant exposures and activities of that covered company, to evaluate the ability of the covered company to absorb losses in specified economic and financial conditions. The analysis includes an assessment of the projected losses, net income, and pro forma capital levels and regulatory capital ratios and other capital ratios for the covered company and uses analytical techniques that the Board determines are appropriate to identify, measure, and monitor risks a covered company may pose to U.S. financial stability.

The Board conducts stress testing analysis using a minimum of two different scenarios: a baseline scenario and a severely adverse scenario. Prior to completing the supervisory stress test, the Federal Reserve will notify covered companies of the scenarios that the Board will apply in analyzing the institution. Regulation YY provides more information on assumptions used when assessing a company’s capital actions over the planning horizon.

Concerning the frequency of these reviews, the Board will conduct annual supervisory stress tests for U.S. GSIBs; Category II BHCs, SLHCs and IHCs; Category III BHCs, SLHCs, and IHCs; and nonbank financial companies supervised by the Board.<sup>32</sup> The Federal Reserve assesses Category IV BHCs, SLHCs and IHCs biennially, occurring in each year ending in an even number.

1060.1.5.1.2 *Comprehensive Capital Analysis and Review*

At the height of the 2008–09 financial crisis, the Board created the Supervisory Capital Assessment Program (SCAP) as a way to help restore confidence in the largest U.S. banking organizations. SCAP estimated potential losses at those firms assuming that economic and financial conditions worsened. The SCAP evolved into the CCAR supervisory exercise. CCAR reflects a number of important steps forward in the Federal Reserve’s approach to the supervision of

the largest BHCs. Rather than evaluating capital at a moment in time, CCAR incorporates a forward looking, post-stress evaluation of a BHC’s capital adequacy. Further, CCAR involves a simultaneous, horizontal assessment of capital adequacy at the largest U.S. BHCs, thus allowing the process to be informed by the financial condition of, and outlook for, these BHCs individually and as a group.

As part of CCAR, the Federal Reserve evaluates institutions’ capital adequacy, internal capital adequacy assessment processes, and their individual plans to make capital distributions, such as dividend payments or stock repurchases.

The Federal Reserve coordinates supervisory stress tests with the CCAR process to reduce duplicative requirements and to minimize regulatory burden.

1060.1.5.2 *Key Supervisory Guidance on the Assessment of Capital at Large Financial Institutions*

Supervisory guidance outlines the agencies’ supervisory expectations or priorities and articulates the agencies’ general views regarding appropriate practices for a given subject area. Further, it often provides examples of practices that the agencies generally consider consistent with safety-and-soundness standards and any other applicable laws and regulations.<sup>33</sup> The following supervisory guidance issuances provide insight to industry, as well as supervisory staff, in a transparent way that helps to ensure consistency in the supervisory approach towards assessing capital at large holding companies.<sup>34</sup>

1060.1.5.2.1 *Large Financial Institution Rating System*

“Large Financial Institution (LFI) Rating System,” [SR-19-3/CA-19-2](#), outlines the ratings framework for BHCs and noninsurance, non-commercial SLHCs with total consolidated assets of \$100 billion or more, and U.S. IHCs of FBOs established under Regulation YY with total consolidated assets of \$50 billion or more. The Capital Planning and Positions rating of the LFI rating system evaluates

32. For more information on the supervisory stress test rule for the SLHCs, see 12 CFR part 238, subpart O.

33. Supervisory guidance does not have the force and effect of law, and the Federal Reserve does not take enforcement actions based on supervisory guidance. See 12 CFR part 262, appendix A.

34. For more information on guidance applicable to large financial holding companies, see the “[Large Banking Organizations](#)” topic page on the Board’s public website.

1. the effectiveness of a firm's governance and planning processes used to determine the amount of capital necessary to cover risks and exposures, and to support activities through a range of conditions and events; and
2. the sufficiency of a firm's capital positions to comply with applicable regulatory requirements and to support the firm's ability to continue to serve as a financial intermediary through a range of conditions.

In developing this rating, the Federal Reserve evaluates

- *Capital planning:* The extent to which a firm maintains sound capital planning practices through effective governance and oversight; effective risk management and controls; maintenance of updated capital policies and contingency plans for addressing potential shortfalls; and incorporation of appropriately stressful conditions into capital planning and projections of capital positions; and
- *Capital positions:* The extent to which a firm's capital is sufficient to comply with regulatory requirements, and to support its ability to meet its obligations to depositors, creditors, and other counterparties and continue to serve as a financial intermediary through a range of conditions.

A firm's capital rating under the LFI rating system reflects a broad assessment, based on horizontal reviews and firm-specific supervisory work focused on capital planning and positions. In consolidating supervisory findings into a comprehensive assessment of a firm's capital planning and positions, the Federal Reserve takes into account the materiality of a firm's outstanding and newly identified supervisory issues.

A firm's compliance with minimum regulatory capital requirements is considered in assigning the firm's Capital Planning and Positions component rating; however, the Federal Reserve may determine that a firm does not meet expectations regarding its capital position in light of its idiosyncratic activities and risks, even if the firm meets minimum regulatory capital requirements. Any findings from supervisory stress testing or CCAR will represent inputs into the Capital Planning and Positions component rating.

See also the section entitled, "Large Financial Institution Rating System" in section 1060.0 of this manual.

#### 1060.1.5.2.2 *Model Risk Management*

"Guidance on Model Risk Management," [SR-11-7](#), is an interagency statement that provides guidance for banks on effective model risk management. A "model" refers to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates. A model consists of three components:

1. an information input component, which delivers assumptions and data to the model
2. a processing component, which transforms inputs into estimates
3. a reporting component, which translates the estimates into useful business information

Models are used for analyzing business strategies, informing business decisions, identifying and measuring risks, valuing exposures, instruments or positions, conducting stress testing, assessing adequacy of capital, managing client assets, measuring compliance with internal limits, maintaining the formal control apparatus of the bank, or meeting financial or regulatory reporting requirements and issuing public disclosures. Rigorous model validation plays a critical role in model risk management; however, sound development, implementation, and use of models are also vital elements. Furthermore, model risk management encompasses governance and control mechanisms such as board and senior management oversight, policies and procedures, controls and compliance, and an appropriate incentive and organizational structure.

#### 1060.1.5.2.3 *Supervisory Guidance on Stress Testing*

In 2012, the Federal Reserve, OCC, and FDIC issued stress testing guidance for larger banking organizations.<sup>35</sup> The guidance emphasizes the importance of stress testing as an ongoing risk management practice that supports banking organizations' forward-looking assessment of risks and better equips them to address a range of adverse outcomes.

<sup>35</sup> See [SR-12-7](#), "Supervisory Guidance on Stress Testing for Banking Organizations with More Than \$10 billion in Total Consolidated Assets."

The guidance describes five principles for banking organizations to consider when designing and implementing a stress testing framework:

- *Principle 1:* A banking organization’s stress testing framework should include activities and exercises that are tailored to and sufficiently capture the banking organization’s exposures, activities, and risks.
- *Principle 2:* An effective stress testing framework employs multiple conceptually sound stress testing activities and approaches.
- *Principle 3:* An effective stress testing framework is forward-looking and flexible.
- *Principle 4:* Stress testing results should be clear, actionable, well supported, and inform decisionmaking.
- *Principle 5:* An organization’s stress testing framework should include strong governance and effective internal controls.

The guidance also describes several approaches and applications that banking organizations should consider using, such as scenario analysis, sensitivity analysis, enterprise-wide stress testing, and reverse stress testing. Organizations should also recognize that stress testing approaches will evolve over time and they should update their practices as needed.

1060.1.5.2.4 *Dividends Policy Statement*

On November 14, 1985, the Federal Reserve Board issued a policy statement on the payment of dividends by state member banks and BHCs. The complete [statement](#) is also available in section 2020.5, “Intercompany Transactions (Dividends),” of this manual. Overall, the policy statement states that as a matter of prudent banking it is generally appropriate for a bank or BHC to continue its existing rate of cash dividends on common stock only if

- the organization’s net income available to common shareholders over the past year has been sufficient to fully fund the dividends; and
- the prospective rate of earnings retention appears consistent with the organization’s capital needs, asset quality, and overall financial condition.

Any banking organization whose cash dividends are inconsistent with either of these criteria should give serious considerations to cutting or eliminating its dividends. Such an action will help conserve the organization’s capital base and help it weather a period of adverse conditions or distress. It is generally inconsistent with prudent banking practices for a banking organization that is experiencing financial problems or that has inadequate capital to borrow to pay dividends; this would result in increased leverage at the very time the organization needs to reduce its debt or conserve its capital. Similarly, the payment of dividends based solely or largely on gains resulting from unusual or nonrecurring events may be imprudent. Unusual or nonrecurring events may include the sale of assets, the effects of accounting changes, the postponement of large expenses to future periods, or negative provisions to the allowance for loan and lease losses.

1060.1.5.2.5 *Supervisory Assessment of Capital Planning and Positions*

“Consolidated Supervision Framework for Large Financial Institutions,” [SR-12-17/CA-12-14](#), outlines core expectations for sound capital planning for LFI. This capital planning and positions guidance provides additional details around the Federal Reserve’s core capital planning expectations for firms subject to Category I standards and firms subject to Category II or III standards, building on the capital planning requirements included in the capital plan rule and the Board’s stress test rules.<sup>36</sup> A firm should maintain a sound capital planning process on an ongoing basis, including in between submissions of its annual capital plan.<sup>37</sup> In addition, this guidance lists broad elements that would be expected of sound capital planning processes. More specifically, to support effective capital planning, and the adequacy of capital positions, each firm should

- maintain strong capital positions that not only comply with regulatory requirements, but also

36. The capital planning process described in this guidance is broadly equivalent to an internal capital adequacy assessment process (ICAAP) under the Federal Reserve’s advanced approaches capital guidelines. The expectations articulated in this document are consistent with the U.S. federal banking agencies’ supervisory guidance relating to the ICAAP (see 73 Fed. Reg. 44,620 (July 31, 2008)).

37. The term “capital planning process” used in this document, which aligns with terminology in [SR-12-17/CA-12-14](#), is equivalent to the term “capital adequacy process” used in other Federal Reserve documents.

support the firm's ongoing ability to meet its obligations to creditors and other counterparties, as well as continue to serve as a financial intermediary through periods of stress;

- have in place robust internal processes that enable the firm to maintain capital commensurate with its unique risks under normal and stressful conditions, and to provide timely restoration of financial buffers in the event of drawdown;
- maintain processes that enable the identification and measurement of potential risks to asset quality, earnings, cash flows, and other primary determinants of capital positions;
- utilize comprehensive projections of the level and composition of capital resources, supported by rigorous and regular stress testing to assess the potential impact of a broad range of expected and potentially adverse scenarios;
- maintain sound risk measurement and modeling capabilities, supported by comprehensive data collection and analysis, independent validation, and effective governance, policies, and controls;
- establish goals for capital positions that are approved by the firm's board of directors and reflect the potential impact of legal or regulatory restrictions on the transfer of capital between legal entities; and
- maintain independent internal audit and other review functions with appropriate staff expertise, experience, and stature in the organization to monitor the adequacy of capital risk measurement and management processes.

In 2021, the Federal Reserve revised [SR-15-18](#), "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category I Standards," and [SR-15-19](#), "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category II or III Standards." While SR-15-18 and SR-15-19 generally apply to the largest BHCs, the principles of the 1985 Policy Statement on the Payment of Dividends are incorporated into these SR letters. Specifically, firms should have comprehensive policies on dividend payments that clearly articulate their objectives and approaches for maintaining a strong capital position and achieving the principles of the policy statement. In addition, the guidance in SR-15-18 and SR-15-19 outlines the Federal Reserve's core capital planning expectations building upon the capital planning requirements in the Federal Reserve's capital plan rule and stress test rules.

More specifically, the guidance outlines capital planning expectations for

- governance,
- risk management,
- internal controls,
- capital policy,
- scenario design, and
- projection methodologies.

Further, the guidance includes several appendices that detail supervisory expectations on a firm's capital planning processes.

### 1060.1.5.3 Collaboration with Other Regulators

In the assessment of capital, as well as the other components of the LFI rating system, the Federal Reserve relies on strong, cooperative relationships with other regulators to implement effective consolidated supervision at the holding company-level. The principle of relying on the work of the insured depository institution regulators is a well-established tenet of Federal Reserve supervisory policy and is required by statute.<sup>38</sup>

The Federal Reserve is expected to rely, to the fullest extent possible, on the information and assessments provided by other regulators to support effective supervision. The views of other regulators may validate the conclusions from Federal Reserve-led supervisory events or fill in information gaps. Federal Reserve examination staff should understand and assess the scope of other regulators' work, including the extent to which transaction testing was performed, as well as the severity of the issues identified. By understanding the work of other regulators, Federal Reserve examiners can ascertain the extent another regulator's findings can be leveraged for assigning ratings under the LFI rating system for the holding company.

38. Refer to sections 5(c)(1)–(2) of the Bank Holding Company Act of 1956 and sections 10(b)(2) and (b)(4) of the Home Owners' Loan Act, as amended by section 604 of the Dodd-Frank Act. 12 U.S.C. 1844(c)(1)–(2); 12 U.S.C. 1467a(b)(2), (b)(4).

# Supervisory Assessment of Capital Planning and Positions

## for Category I Firms

## Section 1060.2

The Federal Reserve issued this guidance (SR-15-18, “Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category I Standards,” and its attachment) to explain its supervisory expectations for capital planning at firms subject to category I standards under the Board’s tailoring framework.<sup>1</sup> Capital is central to a firm’s ability to absorb unexpected losses and continue to lend to creditworthy businesses and consumers. Therefore, a firm’s processes for managing and allocating its capital resources are critical to its financial strength and resilience, as well as the stability and effective functioning of the U.S. financial system. The following guidance provides the Federal Reserve’s core capital planning expectations for firms subject to category I standards, building upon the capital planning requirements in the Federal Reserve’s capital plan rules and stress test rules.<sup>2</sup>

The guidance outlines capital planning expectations for

- governance
- risk management
- internal controls
- capital policy
- scenario design, and
- projection methodologies.

Further, the guidance includes several appendices that detail supervisory expectations for a firm’s capital planning process. This guidance largely consolidates the Federal Reserve’s existing capital planning guidance, including:

- [Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice](#) (August 2013)
- [Comprehensive Capital Analysis and Review 2015 – Summary Instructions and Guidance](#) (October 2014)
- Instructions for the Capital Assessments and Stress Testing information collection ([Reporting Form FR Y-14A](#))
- SR-11-7, “Supervisory Guidance on Model Risk Management” (Refer to section 2126.0 of this manual)
- SR-12-7, “Supervisory Guidance on Stress Testing for Banking Organizations with More Than \$10 Billion in Total Consolidated Assets”
- SR-12-17/CA-12-14, “Consolidated Supervision Framework for Large Financial Institutions”

### 1060.2.1 GUIDANCE ON SUPERVISORY ASSESSMENT OF CAPITAL PLANNING AND POSITIONS FOR CATEGORY I FIRMS

#### *I. Introduction*

This guidance (the attachment to SR-15-18) provides the Federal Reserve’s core capital planning expectations for firms subject to category I standards, building upon the capital planning requirements included in the Board’s capital plan rules and stress test rules. This guidance outlines capital planning expectations for these firms in the following areas:<sup>3</sup>

- governance
- risk management
- internal controls
- capital policy

1. See 84 Fed. Reg. 59,032 (November 1, 2019) for more information on the Board’s tailoring framework. With the issuance of SR-15-18 and SR-15-19, “Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category II or III Standards,” SR-99-18, “Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles,” is superseded. In addition, SR-09-4, “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies,” does not apply to firms subject to SR-15-18 and SR-15-19.

2. For the capital plan rules, refer to section 225.8 of Regulation Y (12 CFR 225.8) and section 238.170 of Regulation LL (12 CFR 238.170). Regulation Q (12 CFR part 217) establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. Regulation YY (12 CFR part 252) and Regulation LL (12 CFR part 238) establish capital stress testing requirements for bank holding companies, U.S. intermediate holding companies of foreign banking organizations, and covered savings and loan holding companies with total consolidated assets of \$100 billion or more.

3. Note that these expectations build upon the capital planning requirements set forth in the Board’s capital plan rules and stress test rules (12 CFR 225.8; 12 CFR part 252, subparts E and F). Other relevant rules pertaining to the Board’s regulatory regime for capital planning and positions are described in section II, “Regulatory Requirements for Capital Positions and Planning.” The Federal Reserve may not conduct or sponsor, and an organization (or a person) is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget (OMB) control number. The OMB control numbers for this guidance are OMB No. 7100-0341 and OMB No. 7100-0342.

- incorporation of stressful conditions and events, and
- estimation of the impact on capital positions.

Further, the following appendixes in the guidance provides detailed supervisory expectations on a firm’s capital planning process:

- A. Use of Models and Other Estimation Approaches
- B. Model Overlays
- C. Use of Benchmark Models in the Capital Planning Process
- D. Sensitivity Analysis and Assumptions Management
- E. Role of the Internal Audit Function in the Capital Planning Process
- F. Capital Policy
- G. Scenario Design
- H. Risk-weighted Asset (RWA) Projections
- I. Operational Loss Projections

This guidance applies to firms that are subject to category I standards.<sup>4</sup> The Federal Reserve has different expectations for sound capital planning and capital adequacy depending on the size, scope of operations, activities, and systemic importance of a firm. The Federal Reserve has separate guidance set forth in SR-15-19 that clarifies that expectations for firms subject to category I standards are higher than the expectations for firms subject to category II or III standards.

*II. Regulatory Requirements for Capital Positions and Planning*

Sound capital planning for any firm begins with adherence to all applicable rules and regulations relating to capital adequacy. Certain Federal Reserve regulations form the basis of the regulatory framework for capital positions and capital planning:

- 1. Regulation Q (12 CFR part 217), Capital Adequacy Requirements for Board-regulated Institutions;

- 2. Regulation YY (12 CFR part 252, subparts E and F) and subparts O and P of Regulation LL (12 CFR part 238, subparts O and P); and
- 3. Section 225.8 of Regulation Y (12 CFR 225.8) and subpart S of Regulation LL (12 CFR part 238, subpart S), together, also known as the capital plan rules).

Regulation Q establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. Among other things, Regulation YY and Regulation LL establish capital stress testing requirements for bank holding companies and covered savings and loan holding companies, respectively, with total consolidated assets of \$100 billion or more. The capital plan rules establish general capital planning requirements for a bank holding company or covered savings and loan holding company with total consolidated assets of \$100 billion or more and requires such a firm to develop an annual capital plan that is approved by its board of directors.

This guidance provides the Federal Reserve’s core capital planning expectations for firms subject to category I standards, building upon the capital planning requirements in the Federal Reserve’s capital plan rules and stress test rules.

*III. Capital Planning Expectations*

Capital is central to a firm’s ability to absorb unexpected losses and continue to lend to credit-worthy businesses and consumers. A firm’s capital planning processes are critical to its financial strength and resilience. At firms subject to category I standards, sound capital planning is also critical to the stability and effective functioning of the U.S. financial system.

SR-12-17/CA-12-14 outlines core expectations for sound capital planning for large financial institutions. This capital planning and positions guidance provides additional details around the Federal Reserve’s core capital planning expectations for firms subject to category I standards and firms subject to category II or III standards, building on the capital planning requirements included in the capital plan rule and the Board’s stress test rules.<sup>5</sup> A firm should

4. This guidance does not apply to nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Board of Governors.

5. The capital planning process described in this guidance is broadly equivalent to an internal capital adequacy assessment process (ICAAP) under the Federal Reserve’s advanced approaches capital guidelines. The expectations articulated in this document are consistent with the U.S. federal banking agencies’ supervisory guidance relating to the ICAAP (see 73 Fed. Reg. 44,620 (July 31, 2008)).

maintain a sound capital planning process on an ongoing basis, including between submissions of its annual capital plan.<sup>6</sup>

## A. Governance

The Federal Reserve expects a firm to have sound governance over its capital planning process. In general, senior management should establish the capital planning process and the board of directors should review and periodically approve that process.

### 1. Board of Directors

A firm's board of directors is ultimately responsible and accountable for the firm's capital-related decisions and for capital planning. The firm's capital planning should be consistent with the strategy and risk appetite set by the board and with the firm's risk levels, including how risks at the firm may emerge and evolve under stress. The board must annually review and approve the firm's capital plan.<sup>7</sup>

The board should direct senior management to provide a briefing on their assessment of the firm's capital adequacy at least quarterly, and whenever economic, financial, or firm-specific conditions warrant a more frequent update. The briefing should describe whether current capital levels and planned capital distributions remain appropriate and consistent with capital goals (see Section III.D, "Capital Policy"). In their briefing, senior management should also highlight for the board any problem areas related to capital planning identified by senior management, internal audit, or supervisors.

The board should hold senior management accountable for providing sufficient information on the firm's material risks and exposures to inform board decisions on capital adequacy and actions, including capital distributions. Information provided to the board should be clear, accurate, and timely. The board should direct senior management to provide this information at least quarterly and whenever economic, financial, or firm-specific conditions warrant a more frequent update. The information presented to the board should include consideration of a number of factors, such as

- macro-economic conditions and relevant market events;
- current capital levels relative to budgets and forecasts;
- post-stress capital goals and targeted real time capital levels (see section III.D, "Capital Policy");
- enterprise-wide and line-of-business performance;
- expectations from stakeholders (including shareholders, regulators, investors, lenders, counterparties, and rating agencies);
- potential sources of stress to the firm's operating performance; and
- risks that may emerge only under stressful conditions.

After receiving the information, the board should be in a position to understand the major drivers of the firm's projections under a range of conditions, including baseline and stress scenarios.

The board should direct senior management to provide information about the firm's estimation approaches, model overlays, and assessments of model performance (see [Appendix A](#), "Use of Models and Other Estimation Approaches," [Appendix B](#), "Model Overlays," and [Appendix C](#), "Use of Benchmark Models in the Capital Planning Process"). The board should also receive information about uncertainties around projections of capital needs or limitations within the firm's capital planning process to understand the impact of these weaknesses on the process. This information should include key assumptions and the analysis of sensitivity of a firm's projections to changes in the assumptions (see [Appendix D](#), "Sensitivity Analysis and Assumptions Management"). The board should incorporate uncertainties in projections and limitations in the firm's capital planning process into its decisions on capital adequacy and capital actions. It should also review and approve mitigating steps to address capital planning process weaknesses.

The board should direct senior management to establish sound controls for the entire capital planning process. The board should approve policies related to capital planning, and review them annually. The board should also approve capital planning activities and strategies. The board of directors should maintain an accurate record of its meetings pertaining to the firm's capital planning process.

6. The term "capital planning process" used herein, which aligns with terminology in SR-12-17/CA-12-14, is equivalent to the term "capital adequacy process" used in other Federal Reserve documents.

7. 12 CFR 225.8(e)(1)(iii).

2. Senior Management

Senior management should direct staff to implement board-approved capital policies, capital planning activities, and strategies in an effective manner. Senior management should make informed recommendations to the board regarding the firm’s capital planning and capital adequacy, including post-stress capital goals and capital distribution decisions. Senior management’s proposed capital goals and capital distributions should have analytical support and take into account the expectations of important stakeholders, including shareholders, rating agencies, counterparties, depositors, creditors, and supervisors.

Senior management should design and oversee the implementation of the firm’s capital planning process; identify and assess material risks and use appropriate firm-specific scenarios in the firm’s stress test; monitor and assess capital planning practices to identify limitations and uncertainties and develop remediation plans; understand key assumptions used throughout a firm’s capital planning process and assess the sensitivity of the firm’s projections to those assumptions (see [Appendix D](#), “Sensitivity Analysis and Assumptions Management”); and review the capital planning process at least quarterly.

Senior management should establish a process for independent review of the firm’s capital planning process, including the elements outlined in this guidance. The independent review process should be designed to identify the weaknesses and limitations of the capital planning process and the potential impact of those weaknesses on the process. Senior management should also develop remediation plans for any identified weaknesses affecting the reliability of capital planning results. Both the specific identified weaknesses and the remediation plans should be reported to the board of directors in a timely manner.

B. Risk Management

A firm should have a risk management infrastructure that appropriately identifies, measures, and assesses material risks and provides a strong foundation for capital planning.<sup>8</sup> This risk management infrastructure should be supported by comprehensive policies and procedures, clear and well-established roles and responsibilities,

and strong and independent internal controls. In addition, the risk management infrastructure should be built upon sound information technology and management information systems. The Federal Reserve’s supervisory assessment of the sufficiency of a firm’s capital planning process will depend in large part on the effectiveness of the firm’s risk management infrastructure and the strength of its process to identify unique risks under normal and stressful conditions, as well as on the strength of its overall governance and internal control processes.

1. Risk Identification and Assessment Process

A firm’s risk identification process should include a comprehensive assessment of risks stemming from its unique business activities and associated exposures. The assessment should include on-balance sheet assets and liabilities, off-balance sheet exposures, vulnerability of the firm’s earnings, and other major firm-specific determinants of capital adequacy under normal and stressed conditions. This assessment should also capture those risks that only materialize or become apparent under stressful conditions.

The specifics of the risk identification process will differ across firms given differences in organizational structure, business activities, and size and complexity of operations. However, the risk identification process at all firms subject to this guidance should be dynamic, inclusive, and comprehensive, and drive the firm’s capital adequacy analysis. A firm should

- evaluate material risks across the enterprise to ensure comprehensive risk capture on an ongoing basis;
- establish a formal risk identification process and evaluate material risks at least quarterly;
- actively monitor its material risks; and
- use identified material risks to inform key aspects of the firm’s capital planning, including the development of stress scenarios, the assessment of the adequacy of post-stress capital levels, and the appropriateness of potential capital actions in light of the firm’s capital objectives.

A firm should be able to demonstrate how material risks are accounted for in its capital planning process. For risks not well captured by scenario analysis, the firm should clearly articulate how the risks are otherwise captured and addressed in the capital planning process and factored into decisions about capital needs and

8. 12 CFR 225.8(e)(2).

distributions. The firm should also be able to identify risks that may be difficult to quantify and explain how these risks are addressed in the capital planning process. The firm should appropriately segment risks beyond generic categories such as credit risk, market risk, and operational risk.

The Federal Reserve expects a firm to seek input from multiple stakeholders across the organization (for example, senior management, finance and risk professionals, front office and line-of-business leadership) in identifying its material risks. In addition, a firm should update its risk assessment at least quarterly to reflect changes in exposures, business activities, and its broader operating environment.

## 2. Risk Measurement and Risk Materiality

A firm should have a sound risk measurement process that informs senior management about the size and risk characteristics of exposures and business activities under both normal and stressful operating conditions. A firm is generally expected to use quantitative approaches supported by expert judgment, as appropriate, for risk-measurement.

Identified weaknesses, limitations, biases, and assumptions in the firm's risk measurement processes should be assessed for their potential impact on the integrity of a firm's capital planning process (see [Appendix D](#), "Sensitivity Analysis and Assumptions Management"). A firm should have a process in place for determining materiality in the context of material risk identification and capital planning. This process should include a sound analysis of relevant quantitative and qualitative considerations, including, but not limited to, the firm's risk profile, size, and complexity, and their effects on the firm's projected regulatory capital ratios in stressed scenarios.<sup>9</sup>

A firm should identify how and where its material risks are accounted for within the capital planning process. The firm should be able to specify material risks that are captured in its scenario design, the approaches used to estimate the impact on capital, and the risk drivers associated with each material risk.

As part of its risk measurement processes, a firm should identify and measure risk that is inherent to its business practices and closely

assess the reliability of assumptions about risk reduction resulting from risk transfer or risk mitigation techniques (see [Appendix D](#), "Sensitivity Analysis and Assumptions Management"). Specifically, the firm should critically assess the enforceability and effectiveness of any guarantees, netting, and collateral agreements. Assumptions about accessibility and valuation of collateral exposures should also be closely reviewed for reliability given the likelihood that asset values will change rapidly in a stressed market.

## C. Internal Controls

A firm should have a sound internal control framework that helps ensure that all aspects of the capital planning process are functioning as designed and result in sound assessments of the firm's capital needs. The framework should include

- an independent internal audit function;
- independent review and validation practices; and
- integrated management information systems, effective reporting, and change control processes.

A firm's internal control framework should support its entire capital planning process, including: the sufficiency of and adherence to policies and procedures; risk identification, measurement, and management practices and systems used to produce input data; and the models, management overlays, and other methods used to generate inputs to post-stress capital estimates. Any part of the capital planning process that relies on manual procedures should receive heightened attention. The internal control framework should also assess the aggregation and reporting process used to produce reports to senior management and to the board of directors and the process used to support capital adequacy recommendations to the board.

In addition, the control framework should include an evaluation of the firm's process for integrating the separate components of the capital planning process at the enterprise-wide level.

9. For simplicity, the terms "quantitative" and "qualitative" are used to describe two different types of approaches, with the recognition that all quantitative estimation approaches involve some qualitative/judgmental aspects, and qualitative estimation approaches produce quantitative output.

## *1. Comprehensive Policies, Procedures, and Documentation for Capital Planning*

A firm should have policies and procedures that support consistent and repeatable capital planning processes.<sup>10</sup> Policies and procedures should describe the capital planning process in a manner that informs internal and external stakeholders of the firm's expectations for internal practices, documentation, and business line controls. The firm's documentation should be sufficient to provide relevant information to those making decisions about capital actions. The documentation should also allow parties unfamiliar with a process or model to understand generally how it operates, as well as its main limitations, key assumptions, and uncertainties.

Policies and procedures should also clearly identify roles and responsibilities of staff involved in capital planning and provide accountability for those responsible for the capital planning process. A firm should also have an established process for policy exceptions. Such exceptions should be approved by the appropriate level of management based upon the gravity of the exception. Policies and procedures should reflect the firm's current practices, and be reviewed and updated as appropriate, but at least annually. A firm should maintain evidence that management and staff are adhering to policies and procedures in practice.

A firm's documentation should cover key aspects of its capital planning process, including its risk-identification, measurement and management practices and infrastructure; methods to estimate inputs to post-stress capital ratios; the process used to aggregate estimates and project capital needs; the process for making capital decisions; and governance and internal control practices. A firm's capital planning documentation should include detailed information to enable independent review of key assumptions, stress testing outputs, and capital action recommendations.

## *2. Model Validation and Independent Review of Estimation Approaches*

Models used in the capital planning process should be reviewed for suitability for their in-

tended uses. A firm should give particular consideration to the validity of models used for calculating post-stress capital positions. In particular, models designed for ongoing business activities may be inappropriate for estimating losses, revenue, and expenses under stressed conditions. If a firm identifies weaknesses or uncertainties in a model, the firm should make adjustments to model output if the findings would otherwise result in the material understatement of capital needs (see [Appendix B](#), "Model Overlays"). If the deficiencies are critical, the firm should restrict the use of the model, apply overlays, or avoid using the model entirely.

A firm should independently validate or otherwise conduct effective challenge of models used in internal capital planning, consistent with supervisory guidance on model risk management.<sup>11</sup> The model review and validation process should include an evaluation of conceptual soundness of models and ongoing monitoring of the model performance. The firm's validation staff should have the necessary technical competencies, sufficient stature within the organization, and appropriate independence from model developers and business areas to provide a critical and unbiased evaluation of the estimation approaches.

A firm should maintain an inventory of all estimation approaches used in the capital planning process, including models used to produce projections or estimates used by the models that generate final loss, revenue, expense, and capital projections.<sup>12</sup> Material models should receive greater attention (see [Appendix C](#), "Use of Benchmark Models in the Capital Planning Process").<sup>13</sup> The intensity and frequency of validation work should be a function of the importance of those models in generating estimates of post-stress capital.

Not all models can be fully validated prior to use in capital planning. However, a firm should conduct a conceptual soundness review of all models prior to their use in capital planning. If such a conceptual soundness review is not possible, the absence of that review should be made transparent to users of model output and the

11. See SR-11-7. The term "effective challenge" means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results.

12. The definition of a model covers quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature.

13. Materiality of the model is a function of both the importance of the business or portfolio assessed and the impact of the model on the firm's overall results.

10. See Instructions for the Capital Planning and Stress Testing Information Collection (Reporting Form FR Y-14A), Appendix A (Supporting Documentation).

firm should determine whether the use of compensating controls (such as conservative adjustments) are warranted.

Further, a firm should treat output from models for which there are model risk management shortcomings with caution. In addition, a firm should have compensating controls for known model uncertainties and apply well supported conservative adjustments to model results, as appropriate.

A firm should ensure that benchmark or challenger models that contribute to post-stress capital estimates or are otherwise used explicitly in the capital planning process are identified and subject to validation (see [Appendix C](#), “Use of Benchmark Models in the Capital Planning Process”).

### 3. Management Information Systems and Change Control Processes

A firm should have internal controls that ensure the integrity of reported results and that make certain the firm is identifying, documenting, reviewing, and tracking all material changes to the capital planning process and its components. The firm should ensure that such controls exist at all levels of the capital planning process. Specific controls should ensure

- sufficiently sound management information systems to support the firm’s capital planning process;
- comprehensive reconciliation and data integrity processes for key reports;
- the accurate and complete presentation of capital planning process results, including a description of adjustments made to compensate for identified weaknesses; and
- that information provided to senior management and the board is accurate and timely.

Many of the processes used to assess capital adequacy, including models, data, and management information systems, are tightly integrated and interdependent. As a result, a firm should ensure consistent change control oversight across the entire firm, in line with existing supervisory guidance.<sup>14</sup> A firm should establish and maintain a policy describing minimum internal control standards for managing change in capital planning process policies and procedures, model development, information technology, and data. Control standards for these areas should address

risk, testing, authorization and approval, timing of implementation, post-installation verification, and recovery, as applicable.

### 4. Internal Audit Function

Internal audit should play a key role in evaluating capital planning and the elements described in this guidance to ensure that the entire process is functioning in accordance with supervisory expectations and the firm’s policies and procedures. Internal audit should review the manner in which deficiencies are identified, tracked, and remediated. Furthermore, internal audit should ensure appropriate independent review and challenge is occurring at all key levels within the capital planning process.

As discussed further in [Appendix E](#), “Role of the Internal Audit Function in the Capital Planning Process,” internal audit staff should have the appropriate competence and influence to identify and escalate key issues. All deficiencies, limitations, weaknesses and uncertainties identified by the internal audit function that relate to the firm’s capital planning process should be reported to senior management, and material deficiencies should be reported to the board of directors (or the audit committee of the board) in a timely manner.<sup>15</sup>

### D. Capital Policy

A capital policy is a firm’s written assessment of the principles and guidelines used for capital planning, issuance, usage, and distributions.<sup>16</sup> This includes internal post-stress capital goals (as discussed in more detail below and in [Appendix F](#), “Estimating Impact on Capital Positions”) and real-time targeted capital levels; guidelines for dividend payments and stock repurchases; strategies for addressing potential capital shortfalls; and internal governance responsibilities and procedures for the capital policy. The capital policy must be approved by the firm’s board of directors or a designated committee of the board.<sup>17</sup>

The capital policy should be reevaluated at least annually and revised as necessary to ad-

15. For additional information on supervisory expectations for internal audit, see [SR-13-1](#), “Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing.”

16. 12 CFR 225.8(d)(7).

17. 12 CFR 225.8(e)(1)(iii).

14. Federal Financial Institutions Examination Council, “[IT Examination Handbook—Operations Booklet](#).”

dress changes to the firm’s business strategy, risk appetite, organizational structure, governance structure, post-stress capital goals, real-time targeted capital levels, regulatory environment, and other factors potentially affecting the firm’s capital adequacy.

A capital policy should describe the firm’s capital adequacy decision-making process, including the decision-making process for common stock dividend payments or stock repurchases.<sup>18</sup> The policy should incorporate actionable protocols, including governance and escalation, in the event a post-stress capital goal, real-time targeted capital level, or other early warning metric is breached. The policy should also include elements such as

- roles and responsibilities of key parties, including those responsible for producing analytical materials, reviewing the analysis, and making capital distribution recommendations and decisions;
- factors and key metrics that influence the size, timing, and form of capital actions, and the analytical materials used in making capital action decisions; and
- the frequency with which capital adequacy will be evaluated and the analysis that will be considered in the determination of capital adequacy, including the specific circumstances that activate the contingency plan.

1. Post-Stress Capital Goals

A firm should establish post-stress capital goals that are aligned with its risk appetite and risk profile, its ability to act as a financial intermediary in times of stress, and the expectations of internal and external stakeholders. Post-stress capital goals should be calibrated based on the firm’s own internal analysis, independent of regulatory capital requirements, of the minimum level of post-stress capital the firm has deemed necessary to remain a going concern over the planning horizon. A firm should also determine targets for real-time capital ratios and

capital levels that ensure that capital ratios and levels would not fall below the firm’s internal post-stress capital goals (including regulatory minimums) under stressful conditions at any point over the planning horizon. For more details, see [Appendix F](#), “Capital Policy.”

E. Incorporating Stressful Conditions and Events

As part of its capital planning process, a firm should incorporate appropriately stressful conditions and events that could adversely affect the firm’s capital adequacy into its capital planning. As part of its capital plan, a firm must use at least one scenario that stresses the specific vulnerabilities of the firm’s activities and associated risks, including those related to the company’s capital adequacy and financial condition.<sup>19</sup> More generally, as part of its ongoing capital adequacy assessment, a firm should use multiple scenarios to assess a broad range of risks, stressful conditions, or events that could impact the firm’s capital adequacy.

1. Scenario design

A firm should develop complete firm-specific scenarios that focus on the specific vulnerabilities of the firm’s risk profile and operations. The scenario design process should be directly linked to the firm’s risk identification process and associated risk assessment. For those aspects of risks not well captured by scenario analysis, the firm should clearly articulate how the risks are otherwise captured and addressed in the capital planning process and factored into decisions about capital needs and distributions.

In developing its scenarios, the firm should recognize that multiple stressful conditions or events can occur simultaneously or in rapid succession. The firm should also consider the cumulative effects of stressful conditions, including possible interactions among the conditions and second-order or “knock-on” effects.

When identifying and developing the specific set of stressful conditions to capture in its stress scenarios, the firm should engage a broad range of internal stakeholders, such as risk experts, business managers, and senior management, to ensure the process comprehensively takes into account the full range of vulnerabilities specific to the firm.

18. Consistent with the Board’s November 14, 1985, Policy Statement on the Payment of Cash Dividends, the principles of which are incorporated into this guidance, firms should have comprehensive policies on dividend payments that clearly articulate the firm’s objectives and approaches for maintaining a strong capital position and achieving the objectives of the policy statement. See [Bank Holding Company Supervision Manual](#), section 2020.5.1.1, Intercompany Transactions (Dividends).

19. 12 CFR 225.8(e)(2).

## 2. Scenario narrative

A firm's stress scenario should be supported by a detailed narrative describing how the scenario addresses the firm's particular material risks and vulnerabilities, and how the paths of the scenario variables relate to each other. The narrative should describe the key attributes of the scenario, including any stress events in the scenario, such as counterparty defaults, large operational risk related events, and ratings downgrades. For more details, see [Appendix G](#), "Scenario Design."

## F. Estimating Impact on Capital Positions

A firm should employ estimation approaches that allow it to project the impact on capital positions of various types of stressful conditions and events. The firm's stress testing practices should capture the potential increase in losses or decrease in pre-provision net revenue (PPNR) that could result from the firm's risks, exposures, and activities under stressful scenarios. A firm should estimate losses, revenues, expenses, and capital using a sound method that relates macroeconomic and other risk drivers to its estimates. The firm should be able to identify the manner in which key variables, factors, and events in a scenario affect losses, revenue, expenses, and capital over the planning horizon. Projections of losses and PPNR should be done at a level of granularity that allows for the appropriate differentiation of risk drivers, while balancing practical constraints such as data limitations (see [Appendix A](#), "Use of Models and Other Estimation Approaches" and [Appendix D](#), "Sensitivity Analysis and Assumptions Management").

The balance sheet projection process should establish and incorporate the relationships among revenue, expense, and on- and off-balance sheet exposures under stressful conditions, including new originations, purchases, sales, maturities, prepayments, defaults, and other borrower and depositor behavior considerations. A firm should also ensure that changes in its asset mix and resulting RWAs are consistent with PPNR and loss estimates. A firm should be able to identify key risk drivers, variables or factors in the scenarios that generate increased losses, reduced revenues, and changes to the balance sheet and RWAs over the planning horizon (see [Appendix H](#), "Risk-weighted Asset (RWA) Projections").

## 1. Loss estimation

A firm should estimate losses using a sound method that relates macroeconomic and other risk drivers to losses. A firm should empirically demonstrate that a strong relationship exists between the variables used in loss estimation and prior losses. When using supervisory scenarios, a firm should project additional scenario variables beyond those included in the supervisory scenarios if the additional variables would be more directly linked to particular portfolios or exposures. A firm should include a variety of loss types in its stress tests based on the firm's exposures and activities. Loss types should include retail and wholesale credit risk losses, credit and fair value losses on securities, market and default risk on trading and counterparty exposures, and operational-risk losses.

### a. Credit risk losses on loans and securities

A firm should develop sound methods to estimate credit losses under stress that take into account the type and size of portfolios, risk characteristics, and data availability. A firm should understand the key characteristics of its loss estimation approach. In addition, a firm's reserves for each quarter of the planning horizon, including the last quarter, should be sufficient to cover estimated loan losses consistent with generally accepted accounting standards. A firm should account for the timing of loss recognition in setting the appropriate level of reserves at the end of each quarter of the planning horizon.

A firm should test credit-sensitive securities for potential other-than-temporary impairment (OTTI) regardless of current impairment status. The threshold for determining OTTI for structured products should be based on cash-flow analysis and credit analysis of underlying obligors.

### b. Fair-value losses on loans and securities

As applicable, a firm should project changes in the fair value of loans and available-for-sale securities (and impaired held-to-maturity securities). The projections should be based on relevant risk drivers, such as changes in credit spreads and interest rates. The firm should ensure that the risk drivers appropriately capture

underlying risk characteristics of the loan or security, including duration and the credit risk of the underlying collateral or issuer.

c. Market and default risks on trading and counterparty exposures

A firm should project how the stress affects mark-to-market values and the default risk of its trading and counterparty exposures. A firm should capture all of its trading positions and counterparty exposures, identify all relevant risk factors, and employ sound revaluation methods. As part of its scenario analysis, as described in greater detail in section III.E of this guidance “Incorporating Stressful Conditions,” a firm should use scenarios that severely stress the firm’s mark-to-market positions and account for the firm’s idiosyncratic risks.

d. Operational-risk losses

A firm should maintain a sound process for estimating operational risk losses in its capital planning process. Operational losses can rise from various sources, including inadequate or failed internal processes, people, and systems, or from external events (see [Appendix I](#), “Operational Loss Projections”).

A firm should have a structured, transparent, and repeatable framework in place to develop credible loss projections under stress that takes into account the differences in loss characteristics of different types of operational loss events. The approaches used to project operational losses should be well supported and include scenario analysis.

2. PPNR

In projecting PPNR, a firm should take into account not only its current positions, but also how its activities, business strategy, and revenue drivers may evolve over time under the varying circumstances and operating environments. The firm should ensure that the various PPNR components, including net interest income, non-interest income and non-interest expense, and other key items projected by the firm such as balance sheet positions, RWA, and losses, are projected in a manner that is internally consistent.

The ability to effectively project net interest income is dependent upon the firm’s ability to identify and aggregate current positions and their attributes; project future changes in accruing balances due to a variety of factors; and appropriately translate the impact of these factors and relevant interest rates into net interest income based on assumed conditions. Accordingly, a firm’s current portfolio of interest-bearing assets and liabilities should serve as the foundation for its forward-looking estimates of net interest income. Beginning positions, positions added during the planning horizon, and the expected behavior of those positions are critical determinants of net interest income. A firm should have the ability to capture these dynamic relationships under its stress scenarios, and should ensure all related assumptions are well supported (see [Appendix D](#), “Sensitivity Analysis and Assumptions Management”).

Non-interest income is derived from a diverse set of sources, including fees, certain realized gains and losses, and mark-to-market income. Non-interest income generally is more susceptible to rapid changes than net interest income, especially if certain market measures move sharply. A firm’s projections should incorporate material factors that could affect the generation of non-interest income under stress, including the firm’s business strategy, the competitive landscape, and changing regulations.

Non-interest expenses include both expenses that are likely to vary with certain stressful conditions and those that are not. Projections of expenses that are closely linked to revenues or balances should vary with projected changes in revenue or balance sheet levels. Non-interest expense should be projected using either quantitative estimation methods or well-supported judgment, depending on the underlying drivers of the expense item.

3. Aggregating Estimation Results

A firm should have well-documented processes for projecting the size and composition of on- and off-balance sheet positions and RWAs over the planning horizon that feed in to the wider capital planning process (see [Appendix H](#), “Risk-weighted Asset (RWA) Projections”).

A firm should have a consistently executed process for aggregating enterprise-wide stress test projections of losses, revenues, and expenses, including estimating on- and off-balance sheet exposures, and RWAs, and for calculating post-stress capital positions and ratios. The aggregation system should be able to bring to-

gether data and information across business lines, portfolios, and risk types and should include the data systems and sources, data reconciliation points, data quality checks, and appropriate internal control points to ensure accurate and consistent projection of financial data within enterprise-wide scenario analysis. Internal processes for aggregating projections from all relevant systems and regulatory templates should be identified and documented. In addition, the beginning points for projections and scenario variables should align with the end of the historical reference period.

## Appendix A: Use of Models and Other Estimation Approaches

Projections of losses and PPNR under various scenarios are key components of enterprise-wide stress testing and capital planning. The firm should ensure that its projection approaches, including any specific processes or methodologies employed, are well supported, transparent, and repeatable over time.

A firm should generally use models or other quantitative methods, supported by expert judgment as appropriate, as the basis for generating projections. In limited instances, such as in cases of new products or businesses, or where insufficient data are available to support modeled approaches, qualitative approaches may be appropriate in lieu of quantitative methods to generate projections for those specific areas.

A firm should adhere to supervisory guidance on model risk management (SR-11-7) when using models, and should have sound internal controls around both quantitative and qualitative approaches.

### 1. Quantitative Approaches

Firms use a range of quantitative approaches for capital planning. The type and level of sophistication of any quantitative approach should be appropriate for the type and materiality of the portfolio or activity for which it is used and the granularity and length of available data. The firm should also ensure that the quantitative approach selected generates credible estimates that are consistent with assumed scenario conditions.

A firm should separately estimate losses and PPNR for portfolios or business lines that are either sensitive to different risk drivers or sensitive to risk drivers in a markedly different way, particularly during periods of stress. For instance,

losses on commercial and industrial loans and commercial real estate (CRE) loans are, in part, driven by different risk factors, with the path of property values having a pronounced effect on CRE loan losses, but not necessarily on other commercial loans. Similarly, although falling property values affect both income-producing CRE loans and construction loans, the effect often differs materially due to structural differences between the two portfolios. Such differences can become more pronounced during periods of stress.

A firm should have a well-supported variable selection process that is based on economic intuition, in addition to statistical significance where applicable. The firm should provide a clear rationale for the macroeconomic variables or other risk drivers chosen for all quantitative approaches, including why certain variables or risk drivers were not selected.

A firm should estimate losses and PPNR at a sufficiently disaggregated level within a given portfolio or business line to capture observed variations in risk characteristics (for example, credit score or loan-to-value ratio ranges for loan portfolios) and performance across sub-portfolios or segments under changing conditions and environments. Loss and PPNR estimates should also be sufficiently granular to capture changing exposure levels over the planning horizon. However, in assessing the appropriate level of granularity of segments, a firm should factor in issues such as the availability of data or the costs and benefits of model complexity. For example, when projecting losses for a more diverse portfolio with a range of borrower risk characteristics and observed historical performance, firms should segment the portfolio more finely based on key risk attributes unless the segments lack sufficient data observations to produce reliable model estimates.

#### a. Use of Data

A firm should use internal data to estimate losses and PPNR as part of its enterprise-wide stress testing and capital planning practices.<sup>20</sup> However, it may be appropriate for a firm to use external data if internal data limitations exist as

20. Firms are required to collect and report a substantial amount of risk information to the Federal Reserve on FR Y-14 schedules. These data may help to support the firms' enterprise-wide stress test. See Capital Assessments and Stress Testing information collection, Reporting Forms FR Y-14A, Q, and M.

a result of systems limitations, acquisitions, or new products, or other factors that may cause internal data to be less relevant for developing stressed estimates. If a firm uses external data to estimate its losses or PPNR, the firm should ensure that the external data reasonably approximate underlying risk characteristics of the firm’s portfolios or business lines. Further, the firm should make adjustments to estimation methods or outputs, as appropriate, to account for identified differences in risk characteristics and performance reflected in internal and external data. In addition, firms should relate their projections under stress scenarios to the characteristics of their assets and activities described in their internal data.

A firm should generally include all available data in its analysis, unless the firm no longer engages in a line of business or its activities have changed such that the firm is no longer exposed to a particular risk. The firm should not selectively exclude data based on the changing nature of the ongoing business or activity without strong empirical support. For example, excluding certain loans only on the basis that they were underwritten to standards that no longer apply or on the basis that the loans were acquired by the firm is not sound practice.

b. Use of Vendor Models<sup>21</sup>

A firm should have processes to confirm that any vendor or other third-party models it uses are sound, appropriate for the given task, and implemented properly. A firm should clearly outline limitations and uncertainties associated with vendor models.

Vendor model management includes having an appropriate vendor selection process, assigning staff to oversee and maintain the vendor relationships, and ensuring that there is sufficient documentation of vendor models. A firm should also confirm that vendor models have been sufficiently tested and that data used by the vendor are appropriate for use at the firm. The firm should also establish key measures for evaluating vendor model performance and tracking those measures whenever those vendor models are used, as well as assess vendor models (including to incorporate any relevant updates or changes). Vendor models should be subject to

validation processes similar to those employed for models developed internally.

2. Assessing Model Performance

A firm should use measures to assess model performance that are appropriate for the type of model being used. The firm should outline how each performance measure is evaluated and used. A firm should also assess the sensitivity of material model estimates to key assumptions and use benchmarking to assess reliability of model estimates (see [Appendix C](#), “Use of Benchmark Models in the Capital Planning Process” and [Appendix D](#), “Sensitivity Analysis and Assumptions Management”).

A firm should employ multiple performance measures and tests, as generally no single measure or test is sufficient to assess model performance. This is particularly the case when the models are used to project outcomes in stressful circumstances. For example, assessing model performance through out-of-sample and out-of-time back testing may be challenging due to the short length of observed data series or the paucity of realized stressed outcomes against which to measure the model performance. When using multiple approaches, the firm should have a consistent framework for evaluating the results of different approaches and supporting rationale for why it chose the methods and estimates ultimately used.

A firm should provide supporting information about models to users of the model output, including descriptions of known measurement problems, simplifying assumptions, model limitations, or other ways in which the model exhibits weaknesses in capturing the relationships being modeled. Providing such qualitative information is critical when certain quantitative criteria or tests measuring model performance are lacking.

3. Qualitative Approaches

A qualitative approach to project losses and PPNR may be appropriate in limited cases where severe data or other limitations preclude the development of reliable quantitative approaches. The firm should document why such an approach is reliable for generating projections and is justified based on business need.

When using a qualitative approach, the firm should substantiate assumptions and estimates using analysis of current and past risk drivers and performance, internal risk identification, forward-looking risk assessments, external analy-

21. See SR-13-19/CA 13-21, “Guidance on Managing Outsourcing Risk.” (Refer to this manual’s section 2124.3)

sis or other available information. The firm should conduct an initial and ongoing assessment of the performance and viability of the qualitative approach. The processes used in qualitative projection approaches should be transparent and repeatable. The firm should also clearly document qualitative approaches and key assumptions used.

Qualitative approaches should be subject to independent review, although the review may differ from the review of quantitative approaches or models. The level of independent review should be commensurate with the

- materiality of the portfolio or business line for which the qualitative approach is used;
- impact of the approach's output on the overall capital results; and
- complexity of the approach.

Firm staff conducting the independent review of the qualitative approaches should *not* be involved in developing, implementing or using the approach. However, this staff can be different than the staff that conducts validation of quantitative approaches or models.

## Appendix B: Model Overlays

A firm may need to rely on overrides or adjustments to model output (model overlay) to compensate for model, data, or other known limitations.<sup>22</sup> If well-supported, use of a model overlay can represent a sound practice.

A model overlay may be appropriate to address cases of identified weaknesses or limitations in the firm's models that cannot be otherwise addressed, or for select portfolios that have unique risks that are not well captured by the model used for those exposures and activities.<sup>23</sup> In contrast, a model overlay that functions as a general "catch all" buffer on top of targeted capital levels to account for model weaknesses generally would not represent sound practice.<sup>24</sup>

22. For the purposes of this appendix, the term "overlays" will be used to cover overrides, overlays, or other adjustments applied to model output. Firms should follow expectations set forth in SR-11-7, relating to overlays.

23. Expectations for the use of judgment within model development is discussed in [Appendix A](#), "Use of Models and Other Estimation Approaches."

24. Firms may choose to apply overall capital buffers as an additional conservative measure, beyond overlays applied at the model level. Overall capital buffers should be subject to the same governance processes applicable to model overlays, as described in section 2 of this appendix. However, supervisors emphasize that having such a buffer should not in any way replace sound model risk management practices for over-

A firm should also avoid extensive reliance on model overlays throughout its capital planning process, particularly for material portfolios or where an overlay would have a large effect on projections. Further, a firm should reduce its reliance on overlays by addressing the underlying model issue over time. Firms should evaluate the reasons for overlays and track and analyze overlay performance.

As part of its overall documentation of methodologies used in stress testing, a firm should document its use of model overlays. Firms must be able to identify the main factors necessitating the use of an overlay as well as how the selected overlay addresses those factors. Key assumptions related to the overlay should be clearly outlined and consistent with assumed scenario conditions.

### 1. Process for Applying Overlays

A firm should establish a consistent firm-wide process for applying model overlays and for controls around model overlays. The process can vary by model type and portfolio, but should contain some key elements, as described below. This process should be outlined in the firm's policies and procedures and include a specific exception process for the use of overlays that do not follow the firm's standards. As part of model development, implementation and use, overlays should be well documented, supported and communicated to senior management. Model overlays should be applied in an appropriate, systematic, and transparent manner. Model results should also be reported to senior management with and without overlay adjustments.

Model overlays (including those based solely on expert or management judgment) should be subject to validation or some other type of effective challenge.<sup>25</sup> Consistent with the materiality principle in SR-11-7, the intensity of model risk management for overlays should be a function of the materiality of the model and overlay. Effective challenge should occur before the model overlay is formally applied, not on an ex-post basis.

lays at the individual model level or address the need for the overlay at the individual model level.

25. The term "effective challenge" means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results.

Validation or other type of effective challenge of model overlays may differ from quantitative model validation. Staff responsible for effective challenge should *not* also be setting the overlay itself or providing significant input to the level or type of overlay. For example, a committee that develops an overlay should not also be responsible for the effective challenge of the overlay. In addition, staff engaging in the effective challenge of model overlays should meet supervisory expectations relating to incentives, competence, and influence (as outlined in SR-11-7). Staff conducting effective challenge should confirm that model overlays are sufficiently conservative to compensate for model limitations and associated uncertainties in model estimates. Sensitivity analysis should be used to help quantify the overlay.

2. Governance of Overlays

Overlays and adjustments used by a firm should be reviewed and approved at a level within the organization commensurate with the materiality of that overlay or adjustment to overall pro forma results. In general, the purpose and impact of overlays should be communicated to senior management in a manner that facilitates an understanding of the issues by the firm’s senior management. Material overlays to the model—either in isolation or in combination—should receive a heightened level of support and scrutiny, up to and including review by the firm’s board of directors (or a designated committee), in instances where the impact on pro forma results is material.

Senior management should periodically receive a high-level description of the use of model overlays. This description should include the number of models having overlays, whether more material models have overlays, whether overlays on the whole result in more or less conservative projections, and the range of the effect of overlays on the model output (especially for those cases where the overlays produce less conservative outcomes).

Senior management should be able to independently assess the reasonableness of using an overlay to capture a particular risk or compensate for a known limitation. Extensive use of overlays should trigger discussion as to whether new or improved modeling approaches are needed to reduce overlay dependency. Signs that the underlying model needs revision or redevelopment

include a high rate of overrides or overrides that consistently affect model performance.

Appendix C: Use of Benchmark Models in the Capital Planning Process

As noted in [Appendix A](#), “Use of Models and Other Estimation Approaches,” a firm should use a variety of methods, including benchmarking, to assess model performance and gain comfort with model estimates. A firm should use benchmark or challenger models to assess the performance of its primary models for all material portfolios or to supplement, where appropriate, the primary models.<sup>26</sup> Such models should be used in conjunction with other aspects of benchmarking, such as comparing model results to actual market data, internal firm data, data from similar firms or portfolios, or judgmental estimates by business line experts. A firm should also use benchmark models during validation as an additional check on the primary model and its results.

Use of benchmark models is particularly important when primary models have exhibited significant deficiencies or are still under development. For instance, a firm’s primary model may use a preferred methodology, but lack a rich data set to support modeled estimates. In these cases, the firm should use benchmark models based on different data and modeling approaches to provide additional checks on primary model estimates. To the extent that a benchmark model highlights that a primary model has flaws (e.g., the model is producing output that is vastly different from experience during prior periods of stress), a firm should analyze whether it would be appropriate to adjust the model specification, apply model overlays, or develop different estimation approaches.

Benchmark models that are developed and run independently of primary models can be used to more effectively calibrate the firm’s final estimates. For example, a firm can use benchmark model outputs to substantiate model overlays, given differences in risk capture between primary and benchmark models. This type of “triangulation” is especially suitable for those areas of modeling that present considerable uncertainty.

Benchmark models used to arrive at the firm’s final estimates should be subject to model risk

26. Note that the terms “benchmark model” and “challenger model” are used interchangeably for purposes of this appendix to mean a model to support or give additional perspective to a primary model.

management. The intensity and frequency of validation or other type of effective challenge of benchmark models of a firm should correspond to the importance of those models in generating estimates. For example, if the output of a benchmark model is averaged with primary model results to develop final estimates, or if the benchmark model is used to develop overlays or overrides for the primary model, that model should be subject to more intensive validation.

Benchmark models that are used only during the validation process and do not contribute directly to the firm's estimates do not need to be validated. However, a firm should assess the rigor of all benchmark models and benchmark data used to ensure they provide reasonable comparisons.

## Appendix D: Sensitivity Analysis and Assumptions Management

A firm should understand the sensitivity of its stress testing estimates used in capital planning to the various inputs and assumptions. In addition, sensitivity analysis should be used to test the robustness of quantitative approaches and models and enhance reporting to the firm's senior management, board of directors, and supervisors. A firm should ensure that it identifies, documents, and manages the use of all key assumptions used in capital planning.

### 1. Sensitivity Analysis

Understanding and documenting a range of potential outcomes provides insight into the inherent uncertainty and imprecision around pro forma results. A firm should assess the sensitivity of its estimates of capital ratios, losses, revenues, and RWAs to key assumptions and uncertainty across the entire firm's projections under stress. Through this assessment, a firm should calculate a range of potential estimates based on changes to assumptions and inputs. Examples of assumptions that generally should be subject to sensitivity analysis include projected market share, size of the market, cost and flow of deposits, utilization rate of credit lines, discount rates, or level and composition of trading assets and RWA.

A firm should also evaluate the sensitivity of models to key assumptions to evaluate model performance, assess the appropriateness of assumptions, and understand uncertainty associated with model output.

Sensitivity analysis for capital planning models should be applied in a manner consistent

with the expectations outlined in the Federal Reserve's supervisory guidance on model risk management (refer to SR-11-7). Sensitivity analysis should be conducted during model development and during model validation to provide information about how models respond to changes in key inputs and assumptions, and how those models perform in stressful conditions. In addition, sensitivity analysis should be applied to understand the range of possible results from vendor-provided models and vendor-provided scenario forecasts that have opaque or proprietary elements. Sensitivity analysis should be used to provide information to help users of model output interpret results, but does not have to result in changes to models or model outputs. Changes made based on sensitivity analysis should be clearly documented and justified.

A firm should ensure that the key sensitivities are presented to senior management and the board in advance of decision-making around the firm's capital plan and capital actions. Sensitivity analysis should also be used to inform senior management, and, as appropriate, the board of directors about the potential uncertainty associated with models employed of the firm's projections under stress.

### 2. Assumptions Management

A firm should clearly document assumptions when estimating losses, PPNR, and balance sheet, and RWA components. Documentation should include the rationale and empirical support for assumptions and specifically address how those assumptions are consistent with and appropriate under the firm's scenario conditions.

A firm's rationale for assumptions used in capital planning should be consistent with the different effects of scenario conditions, shifts in portfolio mix, and growth or decline in balances projected over the planning horizon. For example, the firm should scrutinize and support any assumptions about sizeable loan growth during a severe economic downturn.

A firm should generally use conservative assumptions, particularly in areas of high uncertainty. The firm should provide greater support for assumptions that appear optimistic or otherwise appear to benefit the firm (such as loss reduction or revenue enhancement). A firm should not assume that senior management will be able to realize favorable strategic actions that cannot be reasonably assured in stress scenarios given

the high level of uncertainty around market conditions. Further, a firm should not assume that it would have the perfect foresight that would allow it, for example, to make significant expense reductions in the first quarter of the forecast horizon in anticipation of the forthcoming economic deterioration described in the scenario.

A firm should not always assume that historical patterns will repeat. For example, a firm should not assume that if it has suffered no or minimal losses in a certain business line or product in the past, such a pattern will continue. In addition, a firm should carefully analyze effects of any structural changes in customer base, product, and financial markets on its projections, as these changes could significantly affect a firm's performance under stress scenarios. Furthermore, the firm should explore the potential effects of changes in assumed interrelationships among variables and the behavior of exposures. The firm should also explicitly justify, document, and appropriately challenge any assumptions about diversification benefits.

A firm should confirm that key assumptions used in vendor or other third-party products are transparent and have sufficient support before using the products in stress testing. The firm should limit use of vendor products whose assumptions are not fully transparent or supported or use those products only in conjunction with another approach or compensating controls (e.g., overlays).

Appendix E: Role of the Internal Audit Function in the Capital Planning Process

A firm's internal audit function should play a key role in evaluating the adequacy of the firm's capital planning process and in assessing whether the risk management and internal control practices supporting that process are comprehensive and effective. A firm should establish an audit program around its capital planning process that is consistent with [SR-13-1](#), "Supplemental Policy Statement on the Internal Audit Function and its Outsourcing."

1. Responsibilities of Audit Function

The internal audit function should identify all auditable processes related to capital planning and develop an associated audit plan. The audit

function should also perform substantive testing to ascertain the effectiveness of the control framework supporting the firm's capital planning process, communicate identified limitations and deficiencies to senior management, and communicate material limitations and deficiencies to the board of directors (or the audit committee of the board). The audit function should comprehensively cover the firm's capital planning process.

The internal audit function should perform periodic reviews of all aspects of the internal control framework supporting the capital planning process to ensure that all individual components as well as the entire process are functioning in accordance with supervisory expectations and the firm's policies and procedures. The internal audit function should also review the manner in which deficiencies are identified, tracked, and remediated. Furthermore, the internal audit function should ensure appropriate independent review is occurring at various levels within the capital planning process.

A firm's internal audit staff should have the appropriate competence and stature to identify and escalate key issues when necessary. Adequate quantitative expertise is needed to assess the effectiveness of the capital planning processes and procedures. The role of audit staff is to evaluate whether the capital planning process is comprehensive, rigorous, and effective. The internal audit function may also rely on an independent third party external to the firm to complete some of the substantive testing as long as the internal audit function can demonstrate proper independence of the third-party from the area being assessed and provide oversight over the execution and quality of the work.

Other supervisory expectations for the internal audit function relating to the capital adequacy process include

- verifying that acceptable policies are in place and that staff comply with those policies;
- assessing accuracy and completeness of the model inventory;
- evaluating procedures for updating processes and ensuring appropriate change/version controls;
- confirming that staff are meeting documentation standards, including reporting;
- reviewing supporting operational systems and evaluating the reliability of data used in the capital planning process; and
- reviewing the quality of any work conducted by external parties.

## 2. Development of Audit Plan

The internal audit function should have a documented plan describing its strategy to assess the processes and controls supporting the firm's capital planning process. When defining the annual audit universe and audit plan, the internal audit function of a firm should focus on the most significant risks relating to the capital planning process. The firm may leverage existing or regularly scheduled audits to ensure coverage of all the capital planning process components; however, the findings and conclusions of these audits should be incorporated into the overall summary of audit activities and conclusions regarding the firm's capital planning process.

The internal audit function should also establish a process for reviewing and updating, as appropriate, its audit plan annually to account for material changes to the firm's capital planning process, internal control systems, infrastructure, work processes, business lines, or changes to relevant laws and regulations. The firm should also ensure that the periodic assessment of the capital planning process is supported by a reliable and current assessment of the individual components.

## 3. Briefings to Senior Management and Board

On an annual basis, the internal audit function should report to senior management and the board of directors on the capital planning process to inform recommendations and decisions on the firm's capital plan. The report should provide an opinion of the capital planning process, a statement of the effectiveness of the controls and processes employed, a status update on previously identified issues and remediation plans, and any open issues or uncertainties related to the firm's capital plan. Any key processes that are not comprehensively reviewed and tested, due to timing or significant changes in processes, should be clearly documented and identified as areas with potential heightened risk. In addition, a firm's internal audit function should brief the board of directors (or a designated committee thereof) and senior management at least quarterly on the status of key findings relating to the capital planning process.

The internal audit function should track responses to its findings and report to the board any cases in which senior management is not implementing required changes related to audit findings or is doing so with insufficient inten-

sity. In addition, the internal audit function should report any identified material deficiencies, limitations, or weaknesses related to the firm's capital planning process to the board of directors and senior management in a timely manner.

## Appendix F: Capital Policy

A firm's capital policy should describe how the firm manages, monitors, and makes decisions regarding capital planning.<sup>27</sup> The policy should include internal post-stress capital goals and real-time targeted capital levels; guidelines for dividends and stock repurchases; and strategies for addressing potential capital shortfalls.

A firm's capital policy should describe the manner in which consolidated estimates of capital positions are presented to senior management and the board of directors. The capital policy should require staff with responsibility for developing capital estimates to clearly identify and communicate to senior management and board of directors the key assumptions affecting various components that feed into the aggregate estimate of capital positions and ratios. The capital policy should require that aggregated results be directly compared against the firm's stated post-stress capital goals, and that those comparisons are included within the standard reporting to senior management and the board of directors.

### 1. Post-Stress Capital Goals

Post-stress capital goals should provide specific minimum thresholds for the level and composition of capital that the firm intends to maintain during a stress period. Post-stress capital goals should include any capital measures that are relevant to the firm. The firm should be able to demonstrate through its own internal analysis, independently of regulatory capital requirements, that remaining at or above its internal post-stress capital goals will allow the firm to continue to operate. Capital goals should take into consideration the uncertainty inherent in capital planning, as well as the economic and market outlook.

27. A capital policy is a firm's written assessment of the principles and guidelines used for capital planning, issuance, usage, and distributions. 12 CFR 225.8(d)(7).

The capital policy should describe how senior management and the board concluded that the firm's post-stress capital goals are appropriate, sustainable in different conditions and environments, and consistent with its strategic objectives, business model, and capital plan. In addition, the capital policy should describe the process by which the firm establishes its post-stress capital goals, and include the supporting analysis underpinning the goals chosen by the firm.

A firm should annually review its capital goals, evaluate whether its post-stress capital goals are still appropriate based on changes in operating environment, business mix, or other conditions, and adjust those goals as needed.

A firm should adjust its real-time capital targets (that is the amount of current capital it holds above its post-stress capital goals to ensure it does not fall below those goals under stress) more frequently than it adjusts capital goals, based on changes in the business mix, operating environment, or other current conditions and circumstances.

## 2. Dividends and Stock Repurchases

A firm's capital policy should describe the processes relating to common stock dividend and repurchase decisions, including the processes to determine the timing, form, and amount of all planned distributions. The capital policy should also specify the analysis and metrics that senior management and the board use to make capital distribution decisions. The analysis should include strategic considerations such as new business initiatives, potential acquisitions, and the other relevant factors.

The capital policy should identify the types of calculations and analysis that support a firm's proposed capital actions and determine the amount of capital available for distribution at any given time. For example, a firm should develop and use payout ratio limits in the decision making process. While payout ratio limits or targets should not be the single determining factor, the capital policy should describe how payout ratio limits or targets are considered, including how they are consistent with firm's strategic goals, how they were derived, and what analysis was used to determine the appropriate amount of capital to distribute in a given period. Further, a firm should include in its capital policy threshold levels for payout ratios that trigger management action. Such action should include escalation

to the board and potential suspension of capital distributions. Escalation protocols should be clear, credible, and actionable in the event of an actual or projected target is breached.

## 3. Contingency Plans for Capital Shortfalls

A firm's capital policy should include specific capital contingency actions the firm would take to remedy any current or prospective deficiencies in its capital position. The firm's capital contingency plan should reflect strategies for identifying and addressing potential capital shortfalls and specify circumstances under which the board of directors and senior management will revisit planned capital actions or otherwise institute contingency measures.<sup>28</sup> A contingency plan should include a set of thresholds for metrics or events that provide early warning signs of capital deterioration and that trigger management action or scrutiny.<sup>29</sup> Additionally, triggers for more severe levels of deterioration should be linked to escalation procedures for more immediate management action and should be consistent with triggers in the firm's recovery plan. Triggers should reflect both point-in-time and forward-looking measures (both baseline and stress).

Capital contingency plans should include options for actions that a firm would consider taking to remedy any current or prospective deficiencies in its capital position, such as reducing or ceasing capital distributions, raising additional capital, reducing risk, or employing other means to preserve existing capital. Contingency options in the firm's capital policy should be consequential, realistic, actionable, and comprehensive.

Capital contingency plans should include a detailed explanation of the circumstances in which the firm would consider implementing these options, including when it would reduce or suspend a dividend or repurchase program or not execute a previously planned capital action.

28. Capital contingency planning should be closely integrated with the broader crisis management framework, including recovery and other contingency planning efforts focused on ensuring sustainability under a broad range of internal or external stresses. See [SR-14-1](#), "Heightened Supervisory Expectations for Recovery and Resolution Preparedness for Certain Large Bank Holding Companies," and [SR-14-8](#), "Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies."

29. Capital contingency plans may include triggers for liquidity, earnings, debt and credit default swap spreads, ratings downgrades, stock performance, supervisory actions, general market stress, or other noncapital metrics.

The capital contingency plans should specify the type of information that would be provided to decision makers when the firm's current or projected capital levels have deteriorated, including how management would present options to address the capital position and the long-term viability of the firm. Contingency options should be ranked according to ease of execution and impact and should incorporate an assessment of stakeholder reactions. All options should be evaluated for their feasibility and the reasonableness of underlying assumptions (such as whether a firm would be able to raise capital or draw on capital from another entity during a period of stressful market conditions).

## Appendix G: Scenario Design

As part of its capital plan, a firm must use at least one scenario that stresses the specific vulnerabilities of the firm's risk profile and operations, including those related to the company's capital adequacy and financial condition.<sup>30</sup> The firm's stress scenario should be at least as severe as the Federal Reserve's severely adverse supervisory scenario, measured in terms of its effect on net income and other elements that affect capital.<sup>31</sup>

As noted in the core document, a firm should develop at least one complete firm-specific scenario that focuses on the specific vulnerabilities of the firm's risk profile and operations. The firm's scenario should be carefully tailored to the idiosyncratic risks of the firm, as defined through the firm's internal material risk identification process, and should incorporate circumstances that are particularly stressful to the firm, given the firm's idiosyncratic risks and key vulnerabilities. Such circumstances include those affecting the firm's particular business model, revenue drivers, mix of assets and liabilities, geographic footprint, portfolio characteristics, and specific operational risk vulnerabilities. The firm can incorporate the idiosyncratic stress con-

siderations in macroeconomic and financial market variables or a discrete stress event included in the scenario. A firm-specific scenario would not meet supervisory expectations if it is not tailored to the firm's activities and risks. This is the case even if the severity is generally equivalent to the supervisory stress scenarios or if the post-stress capital ratios are lower than those under the supervisory severely adverse scenario.

The stress scenario should include stressful circumstances and events that could, on a stand-alone basis or in combination, reduce the firm's capital levels and ratios and potentially impede the firm's ability to operate as a going concern, and cover material risks to which the firm is exposed over the course of an annual planning cycle. A firm's scenario should include factors that capture economy- or market-wide stresses and idiosyncratic risks that can put a strain on the firm. A firm should also take into account conditions and events that have not previously occurred, but that may pose a significant threat to the firm given its exposures, risk profile, and business strategy.

### *Use of Multiple Scenarios*

In addition, a firm should use multiple scenarios as part of its ongoing capital adequacy assessment to assess a broad range of risks, stressful conditions, or events that could impact the firm's capital adequacy. This assessment should inform development of the internal stress scenario(s) used in the firm's plan, the firm's post-stress capital goals, and its current capital targets. The firm's scenarios should collectively address all material risks to which the firm is exposed over the course of an annual planning cycle.

In designing its stress scenarios, a firm should incorporate risks and vulnerabilities that arise from multiple factors, sources and events. Historical data may provide a starting point for scenarios, but a firm should also consider other data sources and challenge conventional assumptions when identifying the stressful conditions and events that could adversely affect the firm's capital adequacy. In certain instances, scenarios that include economic and financial market variables that deviate from historical experience and correlations are appropriate if, for example, previously unobserved vulnerabilities exist in certain sectors of the economy or financial markets. In addition, the firm should not exclude experiences that have occurred outside its own history

30. 12 CFR 225.8(e)(2). In addition, a firm is required to report to the Federal Reserve its projections under a baseline scenario, which captures the firm's view of the likely operating environment over the planning horizon. A firm may use the Board's baseline scenario for its own baseline scenario if the firm can demonstrate that the Board's baseline scenario is appropriate for the firm's own risks, activities, and outlook; however, a firm cannot use the Board's severely adverse scenario for its own stress scenario.

31. For guidance on the severity of the scenarios, a firm should review the Board's "Policy Statement on the Scenario Design Framework for Stress Testing," which sets forth the Board's approach to designing the severely adverse scenario. See 12 CFR part 252, appendix A.

when designing stress scenarios, particularly if the firm has recently expanded its business to include new products, markets, or customers.

The macroeconomic variables used in a given scenario should collectively describe the general operational environment considered in the scenario. A firm should ensure that the scenario includes sufficient macroeconomic variables to support its stress testing estimation methods. While a firm should assess the internal consistency of the scenario, the firm should evaluate whether deviations from historically observed relationships among macroeconomic variables that increase the degree of stress placed on the firm may be appropriate.

Depending on the significance of market risk in a firm’s overall risk profile, the firm’s stress scenarios should include an adverse movement in financial market variables, such as asset prices, spreads, and rates, and related risk factors that impact a firm’s trading exposures. The firm should base market risk factors in the scenario on a thorough evaluation of the specific positions of the firm and the material risks coincident with those positions. A firm should limit use of past periods of financial market stress that do not sufficiently stress the firm’s current positions.

Appendix H: Risk-weighted Asset (RWA) Projections

A firm should maintain a sound process for projecting RWAs over the planning horizon. The firm’s initial RWA calculations should be consistent with applicable regulatory capital requirements. In addition, the firm’s projections of RWAs should be developed in a fashion consistent with the scenario conditions and in accordance with applicable regulatory capital requirements.

1. Initial RWA Calculations

Starting balances for both on- and off-balance sheet exposures and applicable risk weights form the foundation for estimates of post-stress capital ratios. Therefore, firms should verify carefully the accuracy of these starting balances. Moreover, deficiencies in starting RWA calculations are generally compounded in RWA projections over the planning horizon. A firm should ensure that it has sound controls around its

RWA calculation and regulatory reporting processes as part of the firm’s broader data governance program.

2. RWA Projections

A firm should ensure that RWA projections are consistent with a given scenario and incorporate the impact of projected changes in exposure amounts and risk characteristics of on- and off-balance sheet exposures under the scenario. A firm should demonstrate that assumptions associated with RWA projections are clearly conditioned on a given scenario and are consistent with stated internal and external business strategies. In addition, firms should ensure that projected market risk-weighted assets (market RWAs) are consistent with market factors (e.g., volatility levels, equity index levels, bond spreads) and assumptions around the size and composition of their trading assets.

A firm should document assumptions for projecting RWAs and their relationship to the RWA projections. If the firm’s models for projecting RWAs rely upon historical relationships, the firm should provide a description of the historical data used and clearly describe why these relationships are expected to be maintained under a given scenario. Further, a firm should analyze the appropriateness of assumptions regarding the following:

- any aggregation of balance projections by exposure type or characteristic (e.g., balances for exposures that do not distinguish between amounts that are considered past due and those that are current) for purposes of applying corresponding risk weights;
- any use of average or effective risk weights based on the firm’s as-of date portfolio composition or historical trend; and
- any exposure types for which RWAs are held constant over the projection horizon.

For purposes of projecting RWAs under the standardized approach, a firm should project balances, risk characteristics, and calculation parameters with appropriate consistency and granularity to facilitate application of appropriate regulatory risk weights for its on- and off-balance sheet exposures.<sup>32</sup> In particular, RWA projections should include information sufficient to assess the impact of potential changes to the following:

32. 12 CFR part 217, subpart D.

- counterparty mix, collateral mix, collateral haircuts, and netting assumptions for derivatives and repo-style transactions;
- default fund assumptions for derivatives that are centrally cleared;
- simplified supervisory formula approach (SSFA) input parameters for securitization exposures;
- organization for Economic Cooperation and Development (OECD) Country Risk Classifications (CRCs) or default status relating to foreign exposures;
- the utilization rate of off-balance sheet lines of credit;
- the mix between unconditionally cancellable and conditionally cancellable off balance sheet exposures;
- the volume of residential mortgage exposures that qualify for 50 percent risk weight, and;
- the volume of past due exposures as defined under Regulation Q.<sup>33</sup>

### 3. Market Risk-weighted Asset Projections

The methods and processes used to project market RWAs will differ across firms, in part as a function of the combination of model and non-model based methods used to determine starting market RWAs. However, as a general matter, market RWAs are expected to be positively correlated to volatility, spreads, or other relevant market factors, holding all things equal. If a firm projects flat or declining market RWAs over the planning horizon under the stress scenarios, the firm should provide support for the reasonableness of these assumptions under stressful market conditions. In addition, the firm should demonstrate that those assumptions are applied consistently across the enterprise-wide stress testing process, including for revenue projections.

If a firm that is not currently subject to the market risk rule projects its trading assets and trading liabilities to grow over the planning horizon, it should assess whether the projected growth would require the firm to calculate market RWA under the regulatory capital rule.<sup>34</sup> The firm should estimate the effect of market RWAs, if applicable, on its projected capital ratios and document the process used to project market RWAs in its capital plan.

### 4. Independent Review of RWA Reporting and Projections

A firm should implement and document an independent review of RWA regulatory reporting by the firm's internal audit function or another independent control function. The independent review should ensure point-in-time RWA calculation processes appropriately capture all relevant on- and off-balance sheet exposures and are consistent with applicable risk-weighting methodologies to which the firm is subject under Regulation Q. The independent review should be conducted by a party with the necessary expertise to perform such reviews but with independence from the assignment of the risk weights for regulatory reporting purposes. The review should provide reasonable assurance that the initial RWAs are accurate and that the methods used to project RWAs are sound. Documentation of the independent review should clearly describe the scope of the review, outcomes and findings of the review, and any associated remediation efforts. A firm should also ensure that the underlying data processes supporting RWA projections include appropriate controls, reconciliations and attestations, and that data integrity testing is conducted by an independent party.

## Appendix I: Operational Loss Projections

A firm faces a wide range of operational risk in conducting its business operations. Operational losses can arise from various sources, including inadequate or failed internal processes, people, and systems, or from external events, and can differ in frequency and severity. For example, some operational loss events, such as credit card fraud, are often more predictable as they occur at high frequency, but generally have low loss severity. The outcome of other events, such as major litigation, are less certain and can result in outsized losses.

### 1. Risk Identification Process

A firm should maintain a sound process for estimating operational risk losses in its capital planning process, taking into account the differences in loss characteristics of different operational loss event types. A firm's risk identification process should include the evaluation of the type of operational risk loss events to which the

33. 12 CFR 217.32(k).

34. 12 CFR 217.201.

firm is exposed and the sensitivity of those events to internal and external operating environments.

The firm-specific scenario submitted in a firm’s capital plan should capture the firm’s material operational risks, be designed with the firm’s particular vulnerabilities in mind, and include potential firm-specific events such as system failures, or litigation-related losses. The firm should evaluate both the firm’s own loss history and the large loss events experienced by industry peers with similar business mix and overall operational risk profiles.

2. *Approaches to Operational Loss Estimation*

The firm should have transparent and well-supported estimation approaches based on both quantitative analysis and expert judgment, and should not rely on unstable or unintuitive correlations to project operational losses. Scenario analysis should be a core component of the firm’s operational loss projection approaches.

Certain operational risks, particularly those most likely to give rise to large losses, often may not have measureable relationships to the overall scenario conditions. In addition, large operational loss events are often idiosyncratic, limiting the relevance of historical data. The firm should also limit dependence on distribution-based approaches that rely on historical data and require significant assumptions when projecting

large operational losses. The firm should evaluate a range of outcomes under various scenarios, and make generally conservative assumptions.

The firm should engage business line and senior management to identify operational risk vulnerabilities and assess ways an operational risk event may unfold. The estimation approaches should also be subject to an effective independent review and challenge process.

3. *Use of Data*

The firm’s operational loss projection approaches should make appropriate use of relevant reference data, including both internal and external data, evaluate all measurable linkages to overall scenario conditions, and include all potential sources of material operational risk losses across the firm. A firm’s internal loss data should serve as both inputs to the firm’s operational loss estimation approaches projections and a benchmark for operational loss estimates in various scenarios. A firm should have sound and comprehensive internal data-collection processes that capture key operational elements. The firm should include all relevant operational loss data, including large operational loss events such as legal settlements and tax and compliance penalties. If a firm’s internal data lack sufficient operational loss history or granularity, the firm should use relevant external data to supplement its internal data.

# Supervisory Assessment of Capital Planning and Positions for Category II or III Firms

## Section 1060.3

The Federal Reserve has issued guidance ([SR-15-19](#), “Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category II or III Standards,” and its attachment) to explain its supervisory expectations for capital planning at firms subject to category II or III standards, consistent with the broad supervisory expectations set forth in [SR-12-17/CA-12-14](#), “Consolidated Supervision Framework for Large Financial Institutions.”<sup>1</sup> Capital is central to a firm’s ability to absorb unexpected losses and continue to lend to credit-worthy businesses and consumers. Therefore, a firm’s processes for managing and allocating its capital resources are critical to its financial strength and resiliency, and also to the stability and effective functioning of the U.S. financial system. The following guidance provides the Federal Reserve’s core capital planning expectations for firms subject to category II or III standards, building upon the capital planning requirements in the Federal Reserve’s capital plan rules and stress test rules.<sup>2</sup>

Firms subject to category I standards are U.S. holding companies identified as global systemically important bank holding companies. Firms subject to category II standards include banking organizations with \$700 billion or more in total consolidated assets; or \$75 billion or more in cross-jurisdictional activity; and do not meet the criteria for category I. Firms subject to category III standards include banking organizations with \$250 billion or more in total consolidated assets; or banking organizations with \$100 bil-

lion or more in total consolidated assets and \$75 billion or more in weighted short-term wholesale funding, total nonbank assets, or off-balance sheet exposure; and do not meet the criteria for category I or II.

The guidance outlines capital planning expectations for

- governance,
- risk management,
- internal controls,
- capital policy,
- scenario design, and
- projection methodologies.

Further, the guidance includes several appendices that detail supervisory expectations on a firm’s capital planning process. This guidance largely consolidates the Federal Reserve’s existing capital planning guidance, including:

- [Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice](#) (August 2013)
- [Comprehensive Capital Analysis and Review 2015 Summary Instructions and Guidance](#) (October 2014)
- Instructions for the Capital Assessments and Stress Testing information collection ([Reporting Form FR Y-14A](#))
- [SR-11-7](#), “Supervisory Guidance on Model Risk Management” (Refer to section 2126.0 of this manual.)
- [SR-12-7](#), “Supervisory Guidance on Stress Testing for Banking Organizations with More Than \$10 Billion in Total Consolidated Assets”
- [SR-12-17/CA-12-14](#), “Consolidated Supervision Framework for Large Financial Institutions.”

### 1060.3.1 GUIDANCE ON SUPERVISORY ASSESSMENT OF CAPITAL PLANNING AND POSITIONS FOR FIRMS SUBJECT TO CATEGORY II OR III STANDARDS

#### I. Introduction

This guidance (the attachment to [SR-15-19](#)) provides the Federal Reserve’s core capital planning expectations for firms subject to category II

1. See 84 Fed. Reg. 59,032 (November 1, 2019) for more information on the Board’s tailoring rules. The term “capital planning process,” as used herein, which aligns with terminology in [SR-12-17/CA-12-14](#), is equivalent to the term “capital adequacy process” used in other Federal Reserve documents. With the issuance of [SR-15-18](#), “Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category I Standards,” and [SR-15-19](#), [SR-99-18](#), “Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles,” is superseded. In addition, [SR-09-4](#), “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies,” is superseded with respect to firms subject to [SR-15-18](#) and [SR-15-19](#).

2. For the capital plan rules, refer to section 225.8 of Regulation Y (12 CFR 225.8) and section 238.170 of Regulation LL (12 CFR 238.170). Regulation Q (12 CFR part 217) establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. Regulation YY (12 CFR part 252) and Regulation LL (12 CFR part 238) establish capital stress testing requirements for bank holding companies (including U.S. intermediate holding companies of foreign banking organizations) and covered savings and loan holding companies, respectively, with total consolidated assets of \$100 billion or more.

or III standards under the Board’s tailoring framework, building upon the capital planning requirements included in the Board’s capital plan rules and stress test rules. This guidance outlines capital planning expectations for these firms in the following areas:<sup>3</sup>

Governance

- risk management
- internal controls
- capital policy
- incorporation of stressful conditions and events, and
- estimation of the impact on capital positions.

Further, the following appendixes in the guidance provides detailed supervisory expectations on a firm’s capital planning process:

- A. Use of Models and Other Estimation Approaches
- B. Model Overlays
- C. Use of Benchmark Models in the Capital Planning Process
- D. Sensitivity Analysis and Assumptions Management
- E. Role of the Internal Audit Function in the Capital Planning Process
- F. Capital Policy
- G. Scenario Design
- H. Risk-weighted Asset (RWA) Projections
- I. Operational Loss Projections

This guidance applies to U.S. bank holding companies and U.S. intermediate holding companies of foreign banking organizations, and covered savings and loan holding companies that are subject to category II or III standards under the Board’s tailoring framework.<sup>4</sup> The

guidance describes minimum examiner expectations when applying the capital plan rules and stress test rules to such firms.

The Federal Reserve has different expectations for sound capital planning and capital adequacy depending on the size, scope of operations, activities, and systemic importance of a firm. The Federal Reserve has separate guidance set forth in SR-15-18, which clarifies that expectations for firms subject to category I standards are higher than the expectations for firms subject to category II or III standards.

II. Regulatory Requirements for Capital Positions and Planning

Sound capital planning for any firm begins with adherence to all applicable rules and regulations relating to capital adequacy. Certain Federal Reserve regulations form the basis of the regulatory framework for capital positions and capital planning:

- (1) Regulation Q (12 CFR part 217), Capital Adequacy Requirements for Board-regulated Institutions;
- (2) Subparts E and F of Regulation YY (12 CFR part 252, subparts E and F), and subparts O and P of Regulation LL (12 CFR part 238, subparts O and P); and
- (3) Section 225.8 of Regulation Y (12 CFR 225.8) and subpart S of Regulation LL (12 CFR part 238, subpart S), together known as the capital plan rules.

Regulation Q establishes minimum capital requirements and overall capital adequacy standards for Federal Reserve-regulated institutions. Among other things, Regulation YY and Regulation LL establish capital stress testing requirements for bank holding companies and covered savings and loan holding companies, respectively, with total consolidated assets of \$100 billion or more. The capital plan rules establish general capital planning requirements for a bank holding company or covered savings and loan holding company with total consolidated assets of \$100 billion or more and requires such a firm to develop an annual capital plan that is approved by its board of directors.

This guidance provides the Federal Reserve’s core capital planning expectations for firms sub-

3. Note that these expectations build upon the capital planning requirements set forth in the Board’s capital plan rules and stress test rules (12 CFR 225.8; 12 CFR part 238, subparts O, P, and S; 12 CFR part 252, subparts E and F). Other relevant rules pertaining to the Board’s regulatory regime for capital planning and positions are described in section II, “Regulatory Requirements for Capital Positions and Planning.” The Federal Reserve may not conduct or sponsor, and an organization (or a person) is not required to respond to, a collection of information unless it displays a currently valid Office of Management and Budget (OMB) control number. The OMB control numbers for this guidance are OMB No. 7100-0341 and OMB No. 7100-0342.

4. This guidance does not apply to nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Board of Governors. A covered savings and loan holding company is a savings and loan

holding company not predominantly engaged in insurance or commercial activities (see 12 CFR 217.2). Firms should refer to this guidance in the development of the capital plans that they will submit by April 5, 2021, and for subsequent years.

ject to this guidance, building upon the capital planning requirements in the Federal Reserve's capital plan rules and stress test rules.

### III. Capital Planning Expectations

Capital is central to a firm's ability to absorb unexpected losses and continue to lend to credit-worthy businesses and consumers. A firm's capital planning processes are critical to its financial strength and resiliency.

SR-12-17/CA-12-14 outlines core expectations for sound capital planning for large financial institutions. This capital planning and positions guidance provides additional details around the Federal Reserve's core capital planning expectations for firms subject to category II or III standards, building on the capital planning requirements included in the capital plan rule and the Board's stress test rules.<sup>5</sup> A firm should maintain a sound capital planning process on an ongoing basis, including in between submissions of its annual capital plan.<sup>6</sup>

#### A. Governance

The Federal Reserve expects a firm to have sound governance over its capital planning process. In general, senior management should establish the capital planning process and the board of directors should review and periodically approve that process.

##### 1. Board of Directors

A firm's board of directors is ultimately responsible and accountable for the firm's capital-related decisions and for capital planning. The firm's capital planning should be consistent with the strategy and risk appetite set by the board and with the firm's risk levels, including how risks at the firm may emerge and evolve under stress. The board must annually review and approve the firm's capital plan.<sup>7</sup>

The board should direct senior management to provide a briefing on their assessment of the firm's capital adequacy at least quarterly, and whenever economic, financial, or firm-specific conditions warrant a more frequent update. The briefing should describe whether current capital levels and planned capital distributions remain appropriate and consistent with capital goals (see Section III.D, "Capital Policy"). In their briefing, senior management should also highlight for the board any problem areas related to capital planning identified by senior management, internal audit, or supervisors.

The board should hold senior management accountable for providing sufficient information on the firm's material risks and exposures to inform board decisions on capital adequacy and actions, including capital distributions. Information provided to the board should be clear, accurate, and timely. The board should direct senior management to provide this information at least quarterly and whenever economic, financial, or firm-specific conditions warrant a more frequent update. The information presented to the board should include consideration of a number of factors, such as

- macro-economic conditions and relevant market events;
- current capital levels relative to budgets and forecasts;
- post-stress capital goals and targeted real time capital levels (see section III.D, "Capital Policy");
- enterprise-wide and line-of-business performance;
- expectations from stakeholders (including shareholders, regulators, investors, lenders, counterparties, and rating agencies);
- potential sources of stress to the firm's operating performance; and
- risks that may emerge only under stressful conditions.

After receiving the information, the board should be in a position to understand the major drivers of the firm's projections under a range of conditions, including baseline and stress scenarios.

The board should direct senior management to provide information about the firm's estimation approaches, model overlays, and assessments of model performance (see [Appendix A](#), "Use of Models and Other Estimation Approaches" and [Appendix B](#), "Model Overlays").

5. The capital planning process described in this guidance is broadly equivalent to an internal capital adequacy assessment process (ICAAP) under the Federal Reserve's advanced approaches capital guidelines. The expectations articulated in this document are consistent with the U.S. federal banking agencies' supervisory guidance relating to the ICAAP (see 73 Fed. Reg. 44,620 (July 31, 2008)).

6. The term "capital planning process" used in this document, which aligns with terminology in SR-12-17/CA-12-14, is equivalent to the term "capital adequacy process" used in other Federal Reserve documents.

7. 12 CFR 225.8(e)(1)(iii).

The board should also receive information about uncertainties around projections of capital needs or limitations within the firm’s capital planning process to understand the impact of these weaknesses on the process. This information should include key assumptions and the analysis of sensitivity of a firm’s projections to changes in the assumptions (see [Appendix D](#), “Sensitivity Analysis and Assumptions Management”). The board should incorporate uncertainties in projections and limitations in the firm’s capital planning process into its decisions on capital adequacy and capital actions. It should also review and approve mitigating steps to address capital planning process weaknesses.

The board should direct senior management to establish sound controls for the entire capital planning process. The board should approve policies related to capital planning, and review them annually. The board should also approve capital planning activities and strategies. The board of directors should maintain an accurate record of its meetings pertaining to the firm’s capital planning process.

2. Senior Management

Senior management should direct staff to implement board-approved capital policies, capital planning activities, and strategies in an effective manner. Senior management should make informed recommendations to the board regarding the firm’s capital planning and capital adequacy, including post-stress capital goals and capital distribution decisions. Senior management’s proposed capital goals and capital distributions should have analytical support and take into account the expectations of important stakeholders, including shareholders, rating agencies, counterparties, depositors, creditors, and supervisors.

Senior management should design and oversee the implementation of the firm’s capital planning process; identify and assess material risks and use appropriate firm-specific scenarios in the firm’s stress test; monitor and assess capital planning practices to identify limitations and uncertainties and develop remediation plans; understand key assumptions used throughout a firm’s capital planning process and assess the sensitivity of the firm’s projections to those assumptions (see [Appendix D](#), “Sensitivity Analysis and Assumptions Management”); and review the capital planning process at least semi-annually.

Senior management should establish a process for independent review of the firm’s capital planning process, including the elements outlined in this guidance. The independent review process should be designed to identify the weaknesses and limitations of the capital planning process and the potential impact of those weaknesses on the process. Senior management should also develop remediation plans for any identified weaknesses affecting the reliability of capital planning results. Both the specific identified weaknesses and the remediation plans should be reported to the board of directors in a timely manner.

B. Risk Management

A firm should have a risk management infrastructure that appropriately identifies, measures, and assesses material risks and provides a strong foundation for capital planning.<sup>8</sup> This risk management infrastructure should be supported by comprehensive policies and procedures, clear and well-established roles and responsibilities, and strong and independent internal controls. In addition, the risk management infrastructure should be built upon sound information technology and management information systems. The Federal Reserve’s supervisory assessment of the sufficiency of a firm’s capital planning process will depend in large part on the effectiveness of the firm’s risk management infrastructure and the strength of its process to identify unique risks under normal and stressful conditions, as well as on the strength of its overall governance and internal control processes.

1. Risk Identification and Assessment Process

A firm’s risk identification process should include a comprehensive assessment of risks stemming from its unique business activities and associated exposures. The assessment should include on-balance sheet assets and liabilities, off-balance sheet exposures, vulnerability of the firm’s earnings, and other major firm-specific determinants of capital adequacy under normal and stressed conditions. This assessment should also capture those risks that only materialize or become apparent under stressful conditions.

The specifics of the risk identification process will differ across firms given differences in organizational structure, business activities, and size

8. 12 CFR 225.8(e)(2).

and complexity of operations. However, the risk identification process at all firms subject to this guidance should be dynamic, inclusive, and comprehensive, and drive the firm's capital adequacy analysis. A firm should

- evaluate material risks across the enterprise to ensure comprehensive risk capture on an on-going basis;
- actively monitor its material risks; and
- use identified material risks to inform key aspects of the firm's capital planning, including the development of stress scenarios, the assessment of the adequacy of post-stress capital levels, and the appropriateness of potential capital actions in light of the firm's capital objectives.

A firm should be able to demonstrate how material risks are accounted for in its capital planning process. For risks not well captured by scenario analysis, the firm should clearly articulate how the risks are otherwise captured and addressed in the capital planning process and factored into decisions about capital needs and distributions.

## 2. Risk Measurement and Risk Materiality

A firm should have a sound risk measurement process that informs senior management about the size and risk characteristics of exposures and business activities under both normal and stressful operating conditions. A firm should employ risk measurement approaches that are appropriate for its size, complexity and risk profile.

Identified weaknesses, limitations, biases, and assumptions in the firm's risk measurement processes should be assessed for their potential impact on the integrity of a firm's capital planning process (see [Appendix D](#), "Sensitivity Analysis and Assumptions Management"). A firm should have a process in place for determining materiality in the context of material risk identification and capital planning. This process should include a sound analysis of relevant quantitative and qualitative considerations, including, but not limited to, the firm's risk profile, size, and complexity, and their effects on the firm's projected regulatory capital ratios in stressed scenarios.<sup>9</sup>

9. For simplicity, the terms "quantitative" and "qualitative" are used to describe two different types of approaches, with the recognition that all quantitative estimation approaches involve some qualitative/judgmental aspects, and qualitative

A firm should identify how and where its material risks are accounted for within the capital planning process. The firm should be able to specify material risks that are captured in its scenario design, the approaches used to estimate the impact on capital, and the risk drivers associated with each material risk.

## C. Internal Controls

A firm should have a sound internal control framework that helps ensure that all aspects of the capital planning process are functioning as designed and result in sound assessments of the firm's capital needs. The framework should include

- an independent internal audit function;
- independent review and validation practices; and
- integrated management information systems, effective reporting, and change control processes.

A firm's internal control framework should support its entire capital planning process, including the sufficiency of and adherence to policies and procedures; risk identification, measurement, and management practices and systems used to produce input data; and the models, management overlays, and other methods used to generate inputs to post-stress capital estimates. Any part of the capital planning process that relies on manual procedures should receive heightened attention. The internal control framework should also assess the aggregation and reporting process used to produce reports to senior management and to the board of directors and the process used to support capital adequacy recommendations to the board.

## 1. Comprehensive Policies, Procedures, and Documentation for Capital Planning

A firm should have policies and procedures that support consistent and repeatable capital planning processes.<sup>10</sup> Policies and procedures should describe the capital planning process in a manner that informs internal and external stakeholders of the firm's expectations for internal prac-

estimation approaches produce quantitative output.

10. See Instructions for the Capital Planning and Stress Testing Information Collection (Reporting Form FR Y-14A), Appendix A (Supporting Documentation).

tices, documentation, and business line controls. The firm’s documentation should be sufficient to provide relevant information to those making decisions about capital actions. The documentation should also allow parties unfamiliar with a process or model to understand generally how it operates, as well as its main limitations, key assumptions, and uncertainties.

Policies and procedures should also clearly identify roles and responsibilities of staff involved in capital planning and provide accountability for those responsible for the capital planning process. A firm should also have an established process for policy exceptions. Such exceptions should be approved by the appropriate level of management based upon the gravity of the exception. Policies and procedures should reflect the firm’s current practices, and be reviewed and updated as appropriate, but at least annually.

2. *Model Validation and Independent Review of Estimation Approaches*

Models used in the capital planning process should be reviewed for suitability for their intended uses. A firm should give particular consideration to the validity of models used for calculating post-stress capital positions. In particular, models designed for ongoing business activities may be inappropriate for estimating losses, revenue, and expenses under stressed conditions. If a firm identifies weaknesses or uncertainties in a material model, the firm should make adjustments to model output if the findings would otherwise result in the material understatement of capital needs (see [Appendix B](#), “Model Overlays”). If the deficiencies are critical, the firm should restrict the use of the model, apply overlays, or avoid using the model entirely.

A firm should independently validate or otherwise conduct effective challenge of models used in internal capital planning, consistent with supervisory guidance on model risk management, with priority given to more material models.<sup>11</sup> The model review and validation process should include an evaluation of conceptual soundness of models and ongoing monitoring of the model performance. The firm’s validation staff

should have the necessary technical competencies, sufficient stature within the organization, and appropriate independence from model developers and business areas to provide a critical and unbiased evaluation of the estimation approaches.

A firm should maintain an inventory of all estimation approaches used in the capital planning process, including models used to produce projections or estimates used by the models that generate final loss, revenue, expense, and capital projections.<sup>12</sup> Material models should receive greater attention.<sup>13</sup> The intensity and frequency of validation work should be a function of the importance of those models in generating estimates of post-stress capital.

Not all models can be fully validated prior to use in capital planning. However, a firm should make efforts to conduct a conceptual soundness review of its material models prior to their use in capital planning. If such a conceptual soundness review is not possible, the absence of that review should be made transparent to users of model output and the firm should determine whether the use of compensating controls (such as conservative adjustments) are warranted.

Further, a firm should treat output from material models for which there are model risk management shortcomings with caution.

3. *Management Information Systems and Change Control Processes*

A firm should have internal controls that ensure the integrity of reported results and that make certain the firm is identifying, documenting, reviewing, and tracking all material changes to the capital planning process and its components. The firm should ensure that such controls exist at all levels of the capital planning process. Specific controls should ensure

- sufficiently sound management information systems to support the firm’s capital planning process;
- comprehensive reconciliation and data integrity processes for key reports;
- the accurate and complete presentation of capital planning process results, including a

11. See [SR-11-7](#). The term “effective challenge” means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results.

12. The definition of a model covers quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature.

13. Materiality of the model is a function of both the importance of the business or portfolio assessed and the impact of the model on the firm’s overall results.

description of adjustments made to compensate for identified weaknesses; and

- that information provided to senior management and the board is accurate and timely.

Many of the processes used to assess capital adequacy, including models, data, and management information systems, are tightly integrated and interdependent. As a result, a firm should ensure consistent change control oversight across the entire firm, in line with existing supervisory guidance.<sup>14</sup> A firm should establish and maintain a policy describing minimum internal control standards for managing change in capital planning process policies and procedures, model development, information technology, and data. Control standards for these areas should address risk, testing, authorization and approval, timing of implementation, and post-installation verification.

#### 4. Internal Audit Function

Internal audit should play a key role in evaluating capital planning and the elements described in this guidance to ensure that the entire process is functioning in accordance with supervisory expectations and the firm's policies and procedures. Internal audit should review the manner in which deficiencies are identified, tracked, and remediated. Furthermore, internal audit should ensure appropriate independent review and challenge is occurring at all key levels within the capital planning process.

As discussed further in [Appendix E](#), "Role of the Internal Audit Function in the Capital Planning Process," internal audit staff should have the appropriate competence and influence to identify and escalate key issues. All deficiencies, limitations, weaknesses and uncertainties identified by the internal audit function that relate to the firm's capital planning process should be reported to senior management, and material deficiencies should be reported to the board of directors (or the audit committee of the board) in a timely manner.<sup>15</sup>

#### D. Capital Policy

A capital policy is a firm's written assessment of the principles and guidelines used for capital

planning, issuance, usage, and distributions.<sup>16</sup> This includes internal post-stress capital goals (as discussed in more detail below and in [Appendix F](#), "Estimating Impact on Capital Positions") and real-time targeted capital levels; guidelines for dividend payments and stock repurchases; strategies for addressing potential capital shortfalls; and internal governance responsibilities and procedures for the capital policy. The capital policy must be approved by the firm's board of directors or a designated committee of the board.<sup>17</sup>

The capital policy should be reevaluated at least annually and revised as necessary to address changes to the firm's business strategy, risk appetite, organizational structure, governance structure, post-stress capital goals, real-time targeted capital levels, regulatory environment, and other factors potentially affecting the firm's capital adequacy.

A capital policy should describe the firm's capital adequacy decision-making process, including the decision-making process for common stock dividend payments or stock repurchases.<sup>18</sup> The policy should incorporate actionable protocols, including governance and escalation, in the event a post-stress capital goal, real-time targeted capital level, or other early warning metric is breached.

#### Post-Stress Capital Goals

A firm should establish post-stress capital goals that are aligned with its risk appetite and risk profile, its ability to act as a financial intermediary in times of stress, and the expectations of internal and external stakeholders. Post-stress capital goals should be calibrated based on the firm's own internal analysis, independent of regulatory capital requirements, of the minimum level of post-stress capital the firm has deemed necessary to remain a going concern over the planning horizon. A firm should also determine targets for real-time capital ratios and

16. 12 CFR 225.8(d)(7).

17. 12 CFR 225.8(e)(1)(iii).

18. Consistent with the Board's November 14, 1985, Policy Statement on the Payment of Cash Dividends, the principles of which are incorporated into this guidance, firms should have comprehensive policies on dividend payments that clearly articulate the firm's objectives and approaches for maintaining a strong capital position and achieving the objectives of the policy statement. See *Bank Holding Company Supervision Manual*, section 2020.5.1.1, "Intercompany Transactions (Dividends)."

14. Federal Financial Institutions Examination Council, "IT Examination Handbook—Operations Booklet."

15. For additional information on supervisory expectations for internal audit see [SR-13-1](#), "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing."

capital levels that ensure that capital ratios and levels would not fall below the firm’s internal post-stress capital goals (including regulatory minimums) under stressful conditions at any point over the planning horizon. For more details, see [Appendix F](#), “Capital Policy.”

E. Incorporating Stressful Conditions and Events

As part of its capital planning process, a firm should incorporate appropriately stressful conditions and events that could adversely affect the firm’s capital adequacy into its capital planning. As part of its capital plan, a firm must use at least one scenario that stresses the specific vulnerabilities of the firm’s activities and associated risks, including those related to the company’s capital adequacy and financial condition.<sup>19</sup>

1. Scenario design

A firm should either develop a complete internal scenario or adjust the Federal Reserve’s supervisory scenarios for the specific vulnerabilities of the firm’s risk profile and operations, as needed, to appropriately capture the firm’s risks (see [Appendix G](#), “Scenario Design”).

2. Scenario narrative

A firm’s stress scenario should be supported by a brief narrative describing how the scenario addresses the firm’s particular material risks and vulnerabilities, and how the paths of the scenario variables relate to each other.

F. Estimating Impact on Capital Positions

A firm should employ estimation approaches that allow it to project the impact on capital positions of various types of stressful conditions and events. The firm’s stress testing practices should capture the potential increase in losses or decrease in pre-provision net revenue (PPNR) that could result from the firm’s risks, exposures, and activities under stressful scenarios. A firm should estimate losses, revenues, expenses,

and capital using a sound method that relates macroeconomic and other risk drivers to its estimates. The firm should be able to identify the manner in which key variables, factors, and events in a scenario affect losses, revenue, expenses, and capital over the planning horizon. The firm may use simple approaches for their non-material portfolios or business lines, such as application of loss or revenue rates during the prior stress periods or other conservative assumptions.

1. Loss estimation

A firm should provide support for the assumed relationship between risk drivers and losses. A firm is expected to estimate losses by type of business activity.

a. Credit risk losses on loans and securities

A firm should develop sound methods to estimate credit losses under stress that take into account the type and size of portfolios, risk characteristics, and data availability. A firm should understand the key characteristics of its loss estimation approach. In addition, a firm’s reserves for each quarter of the planning horizon, including the last quarter, should be sufficient to cover estimated loan losses consistent with generally accepted accounting standards.

A firm should test credit-sensitive securities for potential other-than-temporary impairment (OTTI) regardless of current impairment status. The threshold for determining OTTI for structured products should be based on cash-flow analysis and credit analysis of underlying obligors.

b. Operational-risk losses

A firm should maintain a sound process for estimating operational risk losses in its capital planning process. Operational losses can rise from various sources, including inadequate or failed internal processes, people, and systems, or from external events (see [Appendix I](#), “Operational Loss Projections”).

2. PPNR

In projecting PPNR, a firm should take into account not only its current positions, but also how its activities, business strategy, and revenue drivers may evolve over time under the varying

<sup>19</sup>. 12 CFR 225.8(e)(2).  
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circumstances and operating environments. The firm should ensure that the various PPNR components, including net interest income, non-interest income and non-interest expense, and other key items projected by the firm such as balance sheet positions, RWA, and losses, are projected in a manner that is internally consistent.

The ability to effectively project net interest income is dependent upon the firm's ability to identify and aggregate current positions and their attributes; project future changes in accruing balances due to a variety of factors; and appropriately translate the impact of these factors and relevant interest rates into net interest income based on assumed conditions. Accordingly, a firm's current portfolio of interest-bearing assets and liabilities should serve as the foundation for its forward-looking estimates of net interest income.

Non-interest income is derived from a diverse set of sources, including fees and certain realized gains and losses. Non-interest income generally is more susceptible to rapid changes than net interest income, especially if certain market measures move sharply. A firm's projections should incorporate material factors that could affect the generation of non-interest income under stress, including the firm's business strategy, the competitive landscape, and changing regulations.

Non-interest expenses include both expenses that are likely to vary with certain stressful conditions and those that are not. Projections of expenses that are closely linked to revenues or balances should vary with projected changes in revenue or balance sheet levels.

### 3. Aggregating Estimation Results

A firm should have well-documented processes for projecting the size and composition of on- and off-balance sheet positions and RWAs over the planning horizon that feed in to the wider capital planning process (see [Appendix H](#), "Risk-weighted Asset (RWA) Projections").

A firm should have a consistently executed process for aggregating enterprise-wide stress test projections of losses, revenues, and expenses, including estimating on- and off-balance sheet exposures, and RWAs, and for calculating post-stress capital positions and ratios. The aggregation system should be able to bring together data and information across business lines, portfolios, and risk types and should include the data systems and sources, data reconciliation points, data quality checks, and appropriate in-

ternal control points to ensure accurate and consistent projection of financial data within enterprise-wide scenario analysis. Internal processes for aggregating projections from all relevant systems and regulatory templates should be identified and documented. In addition, the beginning points for projections and scenario variables should align with the end of the historical reference period.

## Appendix A: Use of Models and Other Estimation Approaches

Projections of losses and PPNR under various scenarios are key components of enterprise-wide stress testing and capital planning. The firm should ensure that its material projection approaches, including any specific processes or methodologies employed, are well supported, transparent, and repeatable over time.

A firm may use either quantitative methods or qualitative approaches for generating projections. A firm is not expected to employ a sophisticated modeled approach, particularly if the firm can demonstrate that a simpler approach, combined with well-supported expert judgment, produces credible and transparent output. A firm can apply simple assumptions to generate losses or PPNR for its non-material portfolios or business lines.

A firm should adhere to supervisory guidance on model risk management (SR-11-7) when using models, and should have sound internal controls around both quantitative and qualitative approaches.

### 1. Quantitative Approaches

If a firm decides to employ quantitative approaches, it is not expected to use any specific quantitative estimation method. Any quantitative approach should be appropriate for the type and materiality of the portfolio or activity for which it is used and the granularity and length of available data. The firm should also ensure that the quantitative approach selected generates credible estimates that are consistent with assumed scenario conditions. A firm should separately estimate losses and PPNR for portfolios or business lines that are either sensitive to different risk drivers or sensitive to risk drivers in a markedly different way, particularly during periods of stress.

a. Use of Data

A firm may use either internal or external data to estimate losses and PPNR as part of its enterprise-wide stress testing and capital planning practices.<sup>20</sup> If a firm uses external data to estimate its losses or PPNR, the firm should ensure that the external data reasonably approximate underlying risk characteristics of the firm’s portfolios or business lines. Further, the firm should make adjustments to estimation methods or outputs, as appropriate, to account for identified differences in risk characteristics and performance reflected in internal and external data. If internal data are not available, a firm should strive to collect internal data over time to augment its projections.

For material portfolios and business lines, a firm should generally include all available data in its analysis, unless the firm no longer engages in a line of business or its activities have changed such that the firm is no longer exposed to a particular risk. The firm should not selectively exclude data for material portfolios and business lines based on the changing nature of the ongoing business or activity without strong empirical support. For example, excluding certain loans only on the basis that they were underwritten to standards that no longer apply or on the basis that the loans were acquired by the firm is not sound practice.

b. Use of Vendor Models<sup>21</sup>

A firm should have processes to confirm that any vendor or other third-party models it uses are sound, appropriate for the given task, and implemented properly. A firm should clearly outline limitations and uncertainties associated with vendor models.

2. Assessing Model Performance

A firm should use measures to assess model performance that are appropriate for the type of model being used. The firm should outline how

each performance measure is evaluated and used. A firm should also assess the sensitivity of material model estimates to key assumptions (see [Appendix D](#), “Sensitivity Analysis and Assumptions Management”).

For models used for material portfolios and business lines, a firm should provide supporting information about the models to users of their output, including descriptions of known measurement problems, simplifying assumptions, model limitations, or other ways in which the model exhibits weaknesses in capturing the relationships being modeled. Providing such qualitative information is critical when certain quantitative criteria or tests measuring model performance are lacking.

3. Qualitative Approaches

A firm may use a qualitative approach to project losses and PPNR. When using a qualitative approach for material portfolios and business lines, the firm should substantiate assumptions and estimates using analysis of current and past risk drivers and performance, internal risk identification, forward-looking risk assessments, external analysis or other available information. The firm should conduct an initial and ongoing assessment of the performance and viability of the qualitative approach. The processes used in qualitative projection approaches should be transparent and repeatable. The firm should also clearly document material qualitative approaches and key assumptions used.

Qualitative approaches should be subject to independent review, although the review may differ from the review of quantitative approaches or models. The level of independent review should be commensurate with the

- materiality of the portfolio or business line for which the qualitative approach is used;
- impact of the approach’s output on the overall capital results; and
- complexity of the approach.

Firm staff conducting the independent review of the qualitative approaches should *not* be involved in developing, implementing or using the approach. However, this staff can be different than the staff that conducts validation of quantitative approaches or models.

20. Firms are required to collect and report a substantial amount of risk information to the Federal Reserve on FR Y-14 schedules. These data may help to support the firms’ enterprise-wide stress test. See Capital Assessments and Stress Testing information collection, Reporting Forms FR Y-14A, Q, and M.

21. See [SR-13-19/CA-13-21](#), “Guidance on Managing Outsourcing Risk.”

## Appendix B: Model Overlays

A firm may need to rely on overrides or adjustments to model output (model overlay) to compensate for model, data, or other known limitations.<sup>22</sup> If well-supported, use of a model overlay can represent a sound practice.

A model overlay may be appropriate to address cases of identified weaknesses or limitations in the firm's models that cannot be otherwise addressed, or for select portfolios that have unique risks that are not well captured by the model used for those exposures and activities.<sup>23</sup> In contrast, a model overlay that functions as a general "catch all" buffer on top of targeted capital levels to account for model weaknesses generally would not represent sound practice.<sup>24</sup>

As part of its overall documentation of methodologies used in stress testing, a firm should document its use of model overlays.

### 1. Process for Applying Overlays

A firm should establish a consistent firm-wide process for applying model overlays and for controls around model overlays. The process can vary by model type and portfolio, but should contain some key elements, as described below. This process should be outlined in the firm's policies and procedures and include a specific exception process for the use of overlays that do not follow the firm's standards. As part of model development, implementation and use, overlays for material portfolios and business lines should be well documented, supported and communicated to senior management. Model overlays should be applied in an appropriate, systematic, and transparent manner. Model results should also be reported to senior management with and without overlay adjustments.

Model overlays (including those based solely on expert or management judgment) should be subject to validation or some other type of effective

challenge.<sup>25</sup> Consistent with the materiality principle in SR-11-7, the intensity of model risk management for overlays should be a function of the materiality of the model and overlay. A firm should make efforts to conduct effective challenge of its material overlays prior to their use in capital planning. If such validation or effective challenge is not possible, those instances should be made transparent to users of the model and overlay.

Validation or other type of effective challenge of model overlays may differ from quantitative model validation. Staff responsible for effective challenge should not also be setting the overlay itself or providing significant input to the level or type of overlay. For example, a committee that develops an overlay should not also be responsible for the effective challenge of the overlay. In addition, staff engaging in the effective challenge of model overlays should meet supervisory expectations relating to incentives, competence, and influence (as outlined in SR-11-7).

### 2. Governance of Overlays

Overlays and adjustments used by a firm should be reviewed and approved at a level within the organization commensurate with the materiality of that overlay or adjustment to overall pro forma results. In general, the purpose and impact of material overlays should be communicated to senior management in a manner that facilitates an understanding of the issues by the firm's senior management. Material overlays to the model—either in isolation or in combination—should receive a heightened level of support and scrutiny, up to and including review by the firm's board of directors (or a designated committee), in instances where the impact on pro forma results is material.

## Appendix C: Use of Benchmark Models in the Capital Planning Process

As noted in [Appendix A](#), "Use of Models and Other Estimation Approaches," a firm should use a variety of methods to assess performance of material models and gain comfort with mate-

22. For the purposes of this appendix, the term "overlays" will be used to cover overrides, overlays, or other adjustments applied to model output. Firms should follow expectations set forth in SR-11-7, relating to overlays.

23. Expectations for the use of judgment within model development is discussed in Appendix A, "Use of Models and Other Estimation Approaches."

24. Firms may choose to apply overall capital buffers as an additional conservative measure, beyond overlays applied at the model level. Overall capital buffers should be subject to the same governance processes applicable to model overlays, as described in section 2 of this appendix. However, supervisors emphasize that having such a buffer should not in any way replace sound model risk management practices for overlays at the individual model level or address the need for the overlay at the individual model level.

25. The term "effective challenge" means critical review by objective, informed parties who have the proper incentives, competence, and influence to challenge the model and its results.

rial model estimates. However, a firm is not expected to use benchmark models in its capital planning process.

Appendix D: Sensitivity Analysis and Assumptions Management

A firm should understand the sensitivity of its stress testing estimates used in capital planning to the various inputs and assumptions. In addition, sensitivity analysis should be used to test the robustness of material quantitative approaches and models and enhance reporting to the firm’s senior management, board of directors, and supervisors. A firm should ensure that it identifies, documents, and manages the use of all key assumptions used in capital planning.

1. Sensitivity Analysis

Understanding and documenting a range of potential outcomes provides insight into the inherent uncertainty and imprecision around pro forma results. A firm should assess the sensitivity of its estimates of capital ratios, losses, revenues, and RWAs to key assumptions and uncertainty across the entire firm’s projections under stress. Through this assessment, a firm should calculate a range of potential estimates based on changes to assumptions and inputs.

A firm should also evaluate the sensitivity of material models to key assumptions to evaluate model performance, assess the appropriateness of assumptions, and understand uncertainty associated with model output.

Sensitivity analysis for capital planning models should be applied in a manner consistent with the expectations outlined in the Federal Reserve’s supervisory guidance on model risk management (refer to SR-11-7). Sensitivity analysis should be conducted during model development and during model validation to provide information about how models respond to changes in key inputs and assumptions, and how those models perform in stressful conditions. In addition, sensitivity analysis should be applied to understand the range of possible results from material vendor-provided models and vendor-provided scenario forecasts that have opaque or proprietary elements. Sensitivity analysis should be used to provide information to help users of model output interpret results, but does not have to result in changes to models or

model outputs. Changes made based on sensitivity analysis should be clearly documented and justified.

A firm should ensure that the key sensitivities are presented to senior management and the board in advance of decision-making around the firm’s capital plan and capital actions. Sensitivity analysis should also be used to inform senior management, and, as appropriate, the board of directors about the potential uncertainty associated with models employed of the firm’s projections under stress.

2. Assumptions Management

A firm should clearly document assumptions when estimating losses, PPNR, and balance sheet, and RWA components. Documentation should include the rationale and empirical support for assumptions and specifically address how those assumptions are consistent with and appropriate under the firm’s scenario conditions.

A firm’s rationale for assumptions used in capital planning should be consistent with the different effects of scenario conditions, shifts in portfolio mix, and growth or decline in balances projected over the planning horizon. For example, the firm should scrutinize and support any assumptions about sizeable loan growth during a severe economic downturn.

A firm should generally use conservative assumptions, particularly in areas of high uncertainty. The firm should provide greater support for assumptions that appear optimistic or otherwise appear to benefit the firm (such as loss reduction or revenue enhancement). A firm should not assume that senior management will be able to realize favorable strategic actions that cannot be reasonably assured in stress scenarios given the high level of uncertainty around market conditions. Further, a firm should not assume that it would have the perfect foresight that would allow it, for example, to make significant expense reductions in the first quarter of the forecast horizon in anticipation of the forthcoming economic deterioration described in the scenario.

A firm should confirm that key assumptions used in material vendor or other third-party products are transparent and have sufficient support before using the products in stress testing. The firm should limit use of material vendor products whose assumptions are not fully transparent or supported or use those products only in conjunction with another approach or compensating controls (e.g., overlays).

## Appendix E: Role of the Internal Audit Function in the Capital Planning Process

A firm's internal audit function should play a key role in evaluating the adequacy of the firm's capital planning process and in assessing whether the risk management and internal control practices supporting that process are comprehensive and effective. A firm should establish an audit program around its capital planning process that is consistent with SR-13-1, "Supplemental Policy Statement on the Internal Audit Function and its Outsourcing."

### 1. Responsibilities of Audit Function

The internal audit function should identify all auditable processes related to capital planning and develop an associated audit plan. The audit function should also perform substantive testing to ascertain the effectiveness of the control framework supporting the firm's capital planning process, communicate identified limitations and deficiencies to senior management, and communicate material limitations and deficiencies to the board of directors (or the audit committee of the board). The audit function should comprehensively cover the firm's capital planning process.

The internal audit function should perform periodic reviews of all aspects of the internal control framework supporting the capital planning process to ensure that all individual components as well as the entire process are functioning in accordance with supervisory expectations and the firm's policies and procedures. The internal audit function should also review the manner in which deficiencies are identified, tracked, and remediated. Furthermore, the internal audit function should ensure appropriate independent review is occurring at various levels within the capital planning process.

A firm's internal audit staff should have the appropriate competence and stature to identify and escalate key issues when necessary. The internal audit function may also rely on an independent third party external to the firm to complete some of the substantive testing as long as the internal audit function can demonstrate proper independence of the third-party from the area being assessed and provide oversight over the execution and quality of the work.

### 2. Development of Audit Plan

The internal audit function should have a documented plan describing its strategy to assess the processes and controls supporting the firm's capital planning process. When defining the annual audit universe and audit plan, the internal audit function of a firm should focus on the most significant risks relating to the capital planning process. The firm may leverage existing or regularly scheduled audits to ensure coverage of all the capital planning process components; however, the findings and conclusions of these audits should be incorporated into the overall summary of audit activities and conclusions regarding the firm's capital planning process.

### 3. Briefings to Senior Management and Board

On an annual basis, the internal audit function should report to senior management and the board of directors on the capital planning process to inform recommendations and decisions on the firm's capital plan. The report should provide an opinion of the capital planning process, a statement of the effectiveness of the controls and processes employed, a status update on previously identified issues and remediation plans, and any open issues or uncertainties related to the firm's capital plan. Any key processes that are not comprehensively reviewed and tested, due to timing or significant changes in processes, should be clearly documented and identified as areas with potential heightened risk.

The internal audit function should track responses to its material findings and report to the board any cases in which senior management is not implementing required changes related to audit findings or is doing so with insufficient intensity.

## Appendix F: Capital Policy

A firm's capital policy should describe how the firm manages, monitors, and makes decisions regarding capital planning.<sup>26</sup> The policy should include internal post-stress capital goals and

26. A capital policy is a firm's written assessment of the principles and guidelines used for capital planning, issuance, usage, and distributions. 12 CFR 225.8(d)(7).

real-time targeted capital levels; guidelines for dividends and stock repurchases; and strategies for addressing potential capital shortfalls.

A firm’s capital policy should describe the manner in which consolidated estimates of capital positions are presented to senior management and the board of directors. The capital policy should require staff with responsibility for developing capital estimates to clearly identify and communicate to senior management and board of directors the key assumptions affecting various components that feed into the aggregate estimate of capital positions and ratios. The capital policy should require that aggregated results be directly compared against the firm’s stated post-stress capital goals, and that those comparisons are included within the standard reporting to senior management and the board of directors.

*1. Post-Stress Capital Goals*

Post-stress capital goals should provide specific minimum thresholds for the level and composition of capital that the firm intends to maintain during a stress period. Post-stress capital goals should include any capital measures that are relevant to the firm.

The firm should be able to demonstrate through its own internal analysis, independently of regulatory capital requirements, that remaining at or above its internal post-stress capital goals will allow the firm to continue to operate.

The capital policy should describe how senior management and the board concluded that the firm’s post-stress capital goals are appropriate, sustainable in different conditions and environments, and consistent with its strategic objectives, business model, and capital plan. In addition, the capital policy should describe the process by which the firm establishes its post-stress capital goals, and include the supporting analysis underpinning the goals chosen by the firm.

A firm should annually review its capital goals, evaluate whether its post-stress capital goals are still appropriate based on changes in operating environment, business mix, or other conditions, and adjust those goals as needed.

A firm should adjust its real-time capital targets (that is the amount of current capital it holds above its post-stress capital goals to ensure it does not fall below those goals under stress) more frequently than it adjusts capital

goals, based on changes in the business mix, operating environment or other current conditions and circumstances.

*2. Dividends and Stock Repurchases*

A firm’s capital policy should describe the processes relating to common stock dividend and repurchase decisions, including the processes to determine the timing, form, and amount of all planned distributions. The capital policy should also specify the analysis and metrics that senior management and the board use to make capital distribution decisions. The analysis should include strategic considerations such as new business initiatives, potential acquisitions, and the other relevant factors.

*3. Contingency Plans for Capital Shortfalls*

A firm’s capital policy should include specific capital contingency actions the firm would take to remedy any current or prospective deficiencies in its capital position. The firm’s capital contingency plan should reflect strategies for identifying and addressing potential capital shortfalls and specify circumstances under which the board of directors and senior management will revisit planned capital actions or otherwise institute contingency measures. A contingency plan should include a set of thresholds for metrics or events that provide early warning signs of capital deterioration and that trigger management action or scrutiny.<sup>27</sup>

Capital contingency plans should include options for actions that a firm would consider taking to remedy any current or prospective deficiencies in its capital position, such as reducing or ceasing capital distributions, raising additional capital, reducing risk, or employing other means to preserve existing capital. Contingency options in the firm’s capital policy should be consequential, realistic, actionable, and comprehensive.

**Appendix G: Scenario Design**

As part of its capital plan, a firm must use at least one scenario that stresses the specific vul-

<sup>27</sup> Capital contingency plans may include triggers for liquidity, earnings, debt and credit default swap spreads, ratings downgrades, stock performance, supervisory actions, general market stress, or other noncapital metrics.

nerabilities of the firm's risk profile and operations, including those related to the company's capital adequacy and financial condition.<sup>28</sup> The firm's stress scenario should be at least as severe as the Federal Reserve's severely adverse supervisory scenario, measured in terms of its effect on net income and other elements that affect capital.<sup>29</sup>

As noted in the core document, a firm should create its stress scenario, either by developing a complete internal scenario, or using the Federal Reserve's supervisory scenarios, adjusted for the firm's idiosyncratic risk profile.

The stress scenario should include stressful circumstances and events that could, on a stand-alone basis or in combination, reduce the firm's capital levels and ratios and potentially impede the firm's ability to operate as a going concern, and cover material risks to which the firm is exposed over the course of an annual planning cycle. A firm's scenario should include factors that capture economy- or market-wide stresses and idiosyncratic risks that can put a strain on the firm. A firm should also take into account conditions and events that have not previously occurred, but that may pose a significant threat to the firm given its exposures, risk profile, and business strategy.

## Appendix H: Risk-weighted Asset (RWA) Projections

A firm should maintain a sound process for projecting RWAs over the planning horizon. The firm's initial and projected RWA calculations should be consistent with applicable regulatory capital requirements.

Starting balances for both on- and off-balance sheet exposures and applicable risk weights form the foundation for estimates of post-stress capital ratios. Therefore, firms should verify carefully the accuracy of these starting balances. Moreover, deficiencies in starting RWA calculations are generally compounded in RWA projec-

tions over the planning horizon. A firm should ensure that it has sound controls around its RWA calculation and regulatory reporting processes as part of the firm's broader data governance program.

A firm should ensure that RWA projections are consistent with a given scenario and incorporate the impact of projected changes in exposure amounts and risk characteristics of on- and off-balance sheet exposures under the scenario. A firm should demonstrate that assumptions associated with RWA projections are clearly conditioned on a given scenario and are consistent with stated internal and external business strategies. For example, the firm should demonstrate how projected credit RWAs over the planning horizon are related to projected loan growth under the scenario. A firm should provide documented evidence for the appropriateness of key assumptions used to project RWAs.

## Appendix I: Operational Loss Projections

A firm faces a wide range of operational risk in conducting its business operations. Operational losses can arise from various sources, including inadequate or failed internal processes, people, and systems, or from external events, and can differ in frequency and severity. For example, some operational loss events, such as credit card fraud, are often more predictable as they occur at high frequency, but generally have low loss severity. The outcome of other events, such as major litigation, are less certain and can result in outsized losses.

### 1. Risk Identification Process

A firm should maintain a sound process for estimating operational risk losses in its capital planning process, taking into account the differences in loss characteristics of different operational loss event types. A firm's risk identification process should include the evaluation of the type of operational risk loss events to which the firm is exposed and the sensitivity of those events to internal and external operating environments. The firm-specific scenario submitted in a firm's capital plan should capture the firm's material operational risks.

28. 12 CFR 225.8(e)(2). In addition, a firm is required to report to the Federal Reserve its projections under a baseline scenario, which captures the firm's view of the likely operating environment over the planning horizon. A firm may use the Board's baseline scenario for its own baseline scenario if the firm can demonstrate that the Board's baseline scenario is appropriate for the firm's own risks, activities, and outlook; however, a firm cannot use the Board's severely adverse scenario for its own stress scenario.

29. For guidance on the severity of the scenarios, a firm should review the Board's "Policy Statement on the Scenario Design Framework for Stress Testing," which sets forth the Board's approach to designing the severely adverse scenario. See 12 CFR 252, appendix A.

2. *Approaches to Operational Loss Estimation*

A firm can use a variety of estimation approaches to project operational losses for its enterprise-wide stress testing program, but should not rely on unstable or unintuitive correlations to project operational losses. The firm can use a simple, conservative approach based on historical loss data, such as applying average historical losses, or maximum historical losses, to project operational losses. A firm should also consider the use of scenario analysis to evaluate the

effect of material operational risk events, especially those which are less certain or can result in outsized losses.

3. *Use of Data*

The firm’s operational loss projection approaches should make appropriate use of relevant reference data. The firm should supplement its internal data with relevant external data if the internal data lacks sufficient operational loss history or granularity.

### 1060.20.1 LIQUIDITY

*Liquidity* is a firm's capacity to meet its cash and collateral obligations at a reasonable cost. Maintaining an adequate level of liquidity depends on the firm's ability to efficiently meet both expected and unexpected cash flows and collateral needs without adversely affecting either daily operations or the financial condition of the firm. Liquid assets are cash and assets that can be converted to cash quickly if needed to meet financial obligations. Other examples of liquid assets generally include central bank reserves and government bonds. To remain viable, a firm must have enough liquid assets to meet withdrawals by depositors and other near-term obligations.

*Liquidity risk* is the risk that a firm's financial condition or overall safety and soundness is adversely affected by an inability (or perceived inability) to meet its obligations. A firm's obligations, and the funding sources used to meet them, depend significantly on its business mix, balance-sheet structure, and the cash-flow profiles of its on- and off-balance-sheet obligations.

The purpose of this section is to describe significant guidance issuances and regulations covering liquidity and liquidity risk management. In general, this section focuses on the supervisory assessment of liquidity among firms that are covered by the large financial institution rating system.<sup>1</sup> Below is an outline of the key topics covered in this section:

- [SR-10-6](#), "Interagency Policy Statement on Funding and Liquidity Risk Management"
- [Regulation YY](#), "Enhanced Prudential Standards"
- [Regulation WW](#), "Liquidity Risk Measurement Standards"
  - Liquidity Coverage Ratio
  - Net Stable Funding Ratio
- Liquidity Reporting Requirements
  - [FR 2052a](#) Complex Institution Liquidity Monitoring Report
- Supervisory Considerations for Assessing Liquidity
  - [SR-12-17/CA-12-14](#), "Consolidated Supervision Framework for Large Financial Institutions"
  - Comprehensive Liquidity Analysis and Review

- Large Financial Institutions Ratings System ([SR-19-3/CA-19-2](#))
- CAMELS Ratings ([SR-96-38](#))

### 1060.20.2 INTERAGENCY LIQUIDITY GUIDANCE

The 2008–09 financial crisis demonstrated the importance of effective liquidity risk management to ensure the safety and soundness of firms. Given this experience, supervisors participated in international and national level working groups to assess the lessons learned regarding firms' management of liquidity risk. In September 2008, the Basel Committee on Banking Supervision (BCBS) published "Principles for Sound Liquidity Risk Management and Supervision," which contains 17 principles for managing and supervising liquidity risk.<sup>2</sup>

In 2010, the Federal Reserve and the other supervisors of U.S. depository institutions issued the "Interagency Policy Statement on Funding and Liquidity Risk Management," (2010 policy statement or [SR-10-6](#)).<sup>3</sup> The 2010 policy statement sets forth interagency expectations on sound practices for liquidity risk management that are consistent with established Federal Reserve guidance contained in the [Commercial Bank Examination Manual](#) as well as the "Principles for Sound Liquidity Risk Management and Supervision" published by the BCBS in September 2008.

The 2010 policy statement articulates the process that firms should follow to appropriately identify, measure, monitor, and control their funding and liquidity risks. In particular, the 2010 policy statement re-emphasizes the importance of cash-flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal, well-developed contingency funding plan as primary tools for measuring and managing funding and liquidity risks.

2. [Principles for Sound Liquidity Risk Management and Supervision](#) (September 25, 2008).

3. [SR-10-6](#), "Interagency Policy Statement on Funding and Liquidity Risk Management," and [75 Fed. Reg. 13656](#) (March 22, 2010).

1. [SR-19-3/CA-19-2](#), "Large Financial Institution (LFI) Rating System."

1060.20.2.1 Scope of Application of the 2010 Policy Statement

The Federal Reserve expects all supervised firms to manage their liquidity risk using processes and systems that are commensurate with their complexity, risk profile, and scope of operations.

The 2010 policy statement addresses funding and liquidity risk management at insured depository institutions, including state member banks. The basic principles presented in the 2010 policy statement also apply to bank holding companies (BHCs) as well as savings and loan holding companies (SLHCs).<sup>4</sup> BHCs and SLHCs (collectively, holding companies) should manage and control aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries.

Holding companies should develop and maintain liquidity management processes and funding programs that are consistent with their complexity, risk profile, and scope of operations. Appropriate liquidity risk management is especially important for holding companies since liquidity difficulties can easily spread to both depository and nondepository subsidiaries. Holding companies should ensure that liquidity is sufficient at all levels of the organization to fully accommodate funding needs in periods of stress.

The general principles presented in the 2010 policy statement also apply to foreign banking organizations (FBOs) operating in the United States. The U.S. operations of FBOs are expected to have appropriate liquidity risk-management processes in place that are consistent with established international standards. Supervisory expectations for the U.S. operations of FBOs are the same as those for comparable domestic organizations. FBO branches and agencies are also expected to implement sound liquidity risk-management processes and practices with full recognition that the liquidity risk-management process depends significantly on the specific business models, governance structures, funding approaches, and liquidity risk profiles of the operations. For example, funding dependencies between a branch and home office, and governance structures without boards of directors, may impact a firm’s ability to implement certain

risk-management processes, procedures, systems, or controls for certain standalone legal entities. In such cases, appropriate mitigating controls should be in place.

Liquidity risk for the U.S. operations of FBOs should be managed with processes and systems appropriate for the U.S. entities’ size, complexity, risk profile, and scope of activities. Regardless of the scope or scale of U.S. operations, the risks undertaken are expected to be managed with 1) effective governance and management oversight as appropriate; 2) adequate policies, procedures, and limits on risk taking; and 3) strong management information systems for measuring, monitoring, reporting, and controlling liquidity risks. While elements of these risk-management processes may be implemented locally or outside of the United States, the Federal Reserve expects to have ready access to the information necessary to maintain an understanding and assessment of these functions.

1060.20.2.2 Key Themes of the 2010 Policy Statement

The following subsections summarize the significant themes of SR-10-6 as well as the 2010 policy statement. To review the 2010 policy statement in its entirety, see the “[Interagency Policy Statement on Funding and Liquidity Risk Management](#),” attachment to SR-10-6.

*Liquidity Risk-Management Processes*

Liquidity risk-management processes and funding programs should take into account the firm’s lending, investment, and other activities and should ensure that adequate liquidity is maintained. These processes and programs should fully incorporate real and potential constraints, including legal and regulatory restrictions, on the transfer of funds among subsidiaries and between subsidiaries and the parent holding company. Holding company liquidity should be maintained at levels sufficient to fund holding company and affiliate operations for an extended period of time in a stressed environment when access to normal funding sources are disrupted without having a negative impact on insured depository institution subsidiaries.

Material nonbank subsidiaries, such as broker-dealers, are expected to have liquidity management processes and funding programs that align with the subsidiaries’ complexity, risk profile, and scope of operations. A nonbank subsidiary that directly accesses market sources of funding

4. [SR-14-9](#), “Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program.”

and/or manages specific funding programs should pay particular attention to

- maintaining sufficient liquidity, cash flow, and capital strength to service its debt obligations and cover fixed charges;
- assessing the potential that funding strategies could undermine public confidence in the liquidity or stability of subsidiary depository institutions; and
- ensuring the adequacy of policies and practices addressing the stability of funding and integrity of the firm's liquidity risk profile as evidenced by funding mismatches and the degree of dependence on potentially volatile sources of short-term funding.

### *Corporate Governance*

The Federal Reserve expects the board of directors to provide effective oversight of a firm's liquidity risk and liquidity risk management. The board of directors is ultimately responsible for the liquidity risk assumed by the firm.<sup>5</sup> A firm's senior management is responsible for implementing the policies and risk-management strategies established by the board of directors and are involved in most daily operational decisions.

With regard to a firm's liquidity risk and liquidity risk management, the board of directors or its delegated committee should

- ensure the firm's liquidity risk tolerance is established and communicated in such a manner that all levels of management understand the firm's approach to managing trade-offs between liquidity risk and short-term profits;
- oversee the establishment and approval of liquidity management strategies, policies and procedures, and review them at least annually;
- establish executive-level lines of authority and responsibility for managing the firm's liquidity risk;
- enforce management's duties to identify, measure, monitor, and control liquidity risk; and
- understand and periodically review the firm's contingency funding plan for handling adverse liquidity events and understand the liquidity risk profiles of important subsidiaries and affiliates.

Senior management should

- ensure that board-approved strategies, policies, and procedures for managing liquidity are appropriately executed within the lines of authority and responsibility;
- regularly report to the board of directors on the liquidity risk profile of the firm;
- determine the structure, responsibilities, and controls for managing liquidity risk and for overseeing the liquidity positions of the firm; and
- monitor liquidity risks for each entity across the firm on an ongoing basis.

### *Strategies, Policies, Procedures, and Risk Tolerances*

Firms should have documented strategies for managing liquidity risk and clear policies and procedures for limiting and controlling risk exposures that appropriately reflect the firm's risk tolerances. Firms should consider liquidity costs, benefits, and risks in strategic planning and budgeting processes. Significant business activities should be evaluated for both liquidity risk exposure and profitability.

Effective liquidity risk and risk-management policies and procedures should

- provide for the formulation of plans and courses of actions for dealing with potential temporary, intermediate-term, and long-term liquidity disruptions;
- address liquidity separately for individual currencies, legal entities, and business lines, when appropriate and material;
- articulate a liquidity risk tolerance that is appropriate for the business strategy of the firm;
- employ both quantitative targets and qualitative guidelines for identifying, measuring, and limiting liquidity risk;
- contain provisions for documenting and periodically reviewing assumptions used in liquidity projections; and
- specify the nature and frequency of management reporting.

### *Liquidity Risk Measurement, Monitoring, and Reporting*

#### • Stress Testing

Firms should conduct stress tests regularly for

5. See also [SR-21-3/CA-21-1](#), "Supervisory Guidance on Board of Directors' Effectiveness."

- a variety of firm-specific and market-wide events across multiple time horizons. The magnitude and frequency of stress testing should be commensurate with the complexity of the firm and the level of its risk exposures. Stress test outcomes should be used to identify and quantify sources of potential liquidity strain and to analyze possible impacts on the firm’s cash flows, liquidity position, profitability, and solvency. Stress tests should also be used to ensure that current exposures are consistent with the firm’s established liquidity risk tolerance. The results of stress tests should also play a key role in shaping the firm’s contingency planning. More information on liquidity stress testing for large firms is described in the subsection entitled “[Regulation YY \(12 C.F.R. Part 252\)](#).”
- **Collateral Position Management**  
A firm should be able to calculate all of its collateral positions in a timely manner, including the value of assets currently pledged relative to the amount of security required and unencumbered assets available to be pledged. A firm should monitor available collateral by legal entity, jurisdiction, and currency exposure, and its systems should be able to monitor shifts between intraday and overnight or term collateral usage. A firm should be aware of the operational and timing requirements associated with accessing the collateral given its physical location (i.e., the custodian firm or securities settlement system with which the collateral is held). Firms also should fully understand the potential demand on required and available collateral arising from various types of contractual contingencies during periods of both market-wide and firm-specific stress.
  - **Management Reporting**  
Liquidity risk reports should provide aggregate information with sufficient supporting detail to enable management to assess the sensitivity of the firm to changes in market conditions, its own financial performance, and other important risk factors. The types of reports or information and their timing will vary depending on the firm’s complexity and risk profile. For example, reportable items may include cash-flow gaps, cash-flow projections, asset and funding concentrations, key early warning or risk indicators, as well as the use of and availability of government support.

- **Liquidity across Currencies, Legal Entities, and Business Lines**  
A firm should monitor liquidity risk exposures and funding needs within and across currencies, legal entities, and business lines. A firm should actively monitor and control liquidity risks at the level of individual legal entities, and the consolidated organization, incorporating processes that aggregate data across multiple systems to develop a group-wide view of liquidity risk exposures. Also, a firm should consider operational limitations in the transferability of liquidity, and should maintain sufficient liquidity during economically stressed periods, particularly when there are legal and regulatory restrictions on the transfer of liquidity among regulated entities. A firm’s liquidity risk-management plans should describe assumptions regarding the transferability of funds and collateral.

*Intraday Liquidity Position Management*

Large firms engaged in significant payment, settlement, and clearing activities should actively manage their intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions.

*Diversified Funding*

A firm should establish a funding strategy that provides effective diversification in the sources and tenor of funding. A firm should consider implementing limits to address counterparties, secured versus unsecured market funding, instrument type, securitization vehicle, and geographic market. It should maintain an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources. A firm should periodically assess its ability to access markets and raise new funds. In addition, a firm should identify alternative sources of funding that strengthen its capacity to withstand a variety of severe firm-specific and market-wide liquidity shocks.

*Cushion of Liquid Assets*

A critical component of a firm’s ability to effectively respond to potential liquidity stress is the availability of a cushion of highly liquid assets without legal, regulatory, or operational impediments (i.e., unencumbered) that can be sold or pledged to obtain funds in a range of stress scenarios. Examples of highly liquid assets

include U.S. Treasury securities, securities issued by U.S. government-sponsored agencies, and excess reserves at the central bank. The appropriate cushion of highly liquid assets depends on the risk tolerance and risk profile of the firm, as well as estimates of liquidity needs based on a firm's stress testing.

### *Contingency Funding Plan*

A contingency funding plan (CFP) provides a framework for managing unexpected situations or business conditions that may increase liquidity risk. The objective of the CFP is to ensure that the firm's sources of liquidity are sufficient to fund normal operating needs under contingent liquidity events. A CFP also identifies alternative contingent liquidity resources that can be employed under adverse liquidity circumstances. A firm's CFP should be commensurate with its complexity, risk profile, and scope of operations. Effective CFPs generally should

- identify stress events, which include events that may adversely affect the firm's liquidity given its specific balance-sheet structure, business lines, organizational structure, and other characteristics;
- assess the levels of stress severity that can occur during a contingent liquidity event and identify the different stages for each type of event;
- assess funding sources and needs by providing a quantitative projection and evaluation of expected funding needs and funding capacity during the stress event;
- identify potential alternative sources of liquidity and assess the firm's ability to access such contingent funding sources during a liquidity stress event;
- establish liquidity event-management processes, including a crisis management team and administrative structure, as well as action plans for executing various elements of the CFP depending on given levels of stress; and
- establish a framework for monitoring potential liquidity stress events by using early-warning indicators and event triggers.

### *Internal Controls*

Internal controls consist of procedures, approval processes, reconciliations, reviews, and other mechanisms designed to provide assurance that the firm manages liquidity risk consistent with its board-approved policy. Appropriate internal controls should address relevant elements of the risk-management process, including adherence

to policies and procedures, the adequacy of risk identification, risk measurement, reporting, and compliance with applicable rules and regulations. Management should ensure that an independent party regularly reviews and evaluates the various components of the firm's liquidity risk-management process.

### 1060.20.3 REGULATION YY (12 C.F.R. PART 252)

As discussed in section 1060.1, "Large Financial Institution Rating System: Capital Planning and Positions," the Board adopted enhanced prudential standards to strengthen the resiliency of large banking organizations, including certain FBOs with operations in the United States, and to implement section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>6</sup> These enhanced prudential standards, implemented in the Board's Regulation YY, strengthened the capital and liquidity positions of large banking organizations, and substantially mitigated the risks to safety and soundness and financial stability in the United States. Section 165 of the Dodd-Frank Act directed the Board to establish more stringent prudential standards for BHCs and FBOs with total consolidated assets of \$50 billion or more.<sup>7</sup> In May 2018, Congress enacted the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), which amended section 165 of the Dodd-Frank Act to raise the \$50 billion minimum total consolidated asset threshold to \$250 billion for general application of enhanced prudential standards to BHCs.<sup>8</sup> EGRRCPA also provides the Board with discretion to apply standards to BHCs with total consolidated assets of between \$100 billion and \$250 billion.

In connection with its implementation of EGRRCPA and as part of the Board's periodic efforts to improve the risk sensitivity of its regulations, the Board revised Regulation YY by establishing categories of prudential standards applicable to BHCs, certain SLHCs, and

6. 12 U.S.C. 5365.

7. 12 U.S.C. 5365.

8. Pub. L. No. 115-174, 132 Stat. 1296 (2018). The term "bank holding company" as used in section 165 of the Dodd-Frank Act includes a foreign bank or company treated as a bank holding company for purposes of the BHC Act, pursuant to section 8(a) of the International Banking Act of 1978. See 12 U.S.C. 3106(a); 12 U.S.C. 5311(a)(1).

FBOs to align those requirements with a firm’s risk profile and to apply consistent standards across similarly situated firms.

In particular, Regulation YY establishes risk-based indicators to differentiate firms based on their size, cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, and off-balance sheet exposure, and whether a firm is identified as a U.S. global systemically important BHC (U.S. G-SIB). For more information on the firms that are covered by each of the four categories of standards, see section 1060.1 of this manual, “Large Financial Institution Rating System: Capital Planning and Positions” (table 1).

1060.20.3.1 Liquidity Requirements of Regulation YY

The liquidity risk-management requirements in Regulation YY build upon the Board’s overall supervisory framework for liquidity adequacy and liquidity risk management.<sup>9</sup> Regulation YY is designed to provide a regulatory framework for ensuring that large BHCs and FBOs establish and maintain robust liquidity risk-management practices, perform internal stress tests for determining the adequacy of their liquidity resources, and maintain a buffer of highly liquid assets in the United States to cover cash-flow needs under stress.

1060.20.3.1.1 Liquidity Risk-Management Requirements

The Board’s Regulation YY outlines the liquidity risk-management requirement for large BHCs (12 C.F.R. 252.34) and FBOs (12 C.F.R. 252.156) covered by the rule.<sup>10</sup> This part of the regulation describes governance responsibilities, namely the responsibilities of a firm’s board of directors, risk committee, and senior management as well as the need to establish an independent review function. In addition, this section of the regulation describes other liquidity risk-management requirements covering cash-flow projections, contingency funding planning, liquidity risk limits, and liquidity risk monitoring. Many elements of the liquidity risk-management

requirements apply to all firms covered by Regulation YY. However, certain elements of the liquidity risk-management requirements do not apply to Category IV firms. This section summarizes Regulation YY’s liquidity risk-management requirements. Refer to the regulation for comprehensive information on liquidity risk-management requirements.

Board of Directors (BHC) and U.S. Risk Committee (FBO)

The board of directors of covered BHCs and U.S. risk committee of covered FBOs is responsible for oversight of liquidity risk management and is required to<sup>11</sup>

- approve the firm’s liquidity risk tolerance at least annually;<sup>12</sup> and
- receive and review information from senior management at least semiannually to determine whether the firm is operating in accordance with its established liquidity risk tolerance.

In addition, a BHC’s board of directors must approve and periodically review the liquidity risk-management strategies, policies, and procedures established by senior management.

Risk Committee

The risk committee of a covered BHC or covered FBO is responsible for understanding the liquidity risks associated with different business lines and products and must be composed of a subset of directors with the appropriate level of risk-management expertise to conduct an in-depth review of the CFP.<sup>13</sup> The risk committee, or a designated subcommittee thereof, is required to review and approve the CFP at least annually and prior to the implementation of material revisions.

Senior Management

Concerning the management of liquidity risk, Regulation YY requires a covered BHC’s senior management to

9. For example, supervisory guidance regarding liquidity risk-management practices includes the 2010 policy statement, which is described in subsection 1060.20.2.

10. For large SLHCs, see 12 C.F.R. 238.123.

11. An FBO may maintain its U.S. risk committee at either the global board of directors or at the FBO’s U.S. intermediate holding company.

12. The liquidity risk tolerance is the acceptable level of liquidity risk that a firm may assume in connection with its operating strategies.

13. For an FBO, the U.S. risk committee or a designated subcommittee of such committee may be composed of members of the board of directors (or the equivalent thereof) of the FBO or its U.S. intermediate holding company.

- establish and implement strategies, policies, and procedures designed to effectively manage risk;
- oversee the development and implementation of liquidity risk measurement and reporting systems;
- determine whether the firm is operating in accordance with such policies and produces at least quarterly or more often, if conditions change; and
- report to the board of directors or the risk committee regarding the firm's liquidity risk profile and liquidity risk tolerance at least quarterly or more often if conditions change.

Regulation YY requires a covered FBO's U.S. chief risk officer to

- review the strategies, policies, and procedures established by senior management of the U.S. operations for managing liquidity risk;
- review information provided by senior management of the U.S. operations to determine whether the combined U.S. operations are operating in accordance with the established liquidity risk tolerance; and
- report at least semi-annually to the FBO's U.S. risk committee and enterprise-wide risk committee (or the equivalent thereof) on the liquidity risk profile of the FBO's combined U.S. operations and whether it is operating in accordance with the established liquidity risk tolerance.

Senior management of a covered BHC and the U.S. chief risk officer of a covered FBO must

- approve new products and business lines and evaluate liquidity costs, benefits, and risks related to each new business line and product that could have a significant effect on the firm's liquidity risk profile;<sup>14</sup>
- review required cash-flow projections at least quarterly;
- establish the liquidity risk limits specified in the regulation and review the firm's compliance with those limits at least quarterly; and
- review and approve certain aspects of the liquidity stress testing framework and the liquidity buffer at specified intervals.

### *Independent review function*

Covered BHCs (12 C.F.R. 252.34(d)) and FBOs (12 C.F.R. 252.156(c)) are required to establish and maintain a review function, which is independent of management functions that execute funding, to evaluate its liquidity risk management. The independent review function must

- review and evaluate the adequacy and effectiveness of the firm's liquidity risk-management processes, including its liquidity stress test processes and assumptions, regularly, but no less frequently than annually;
- assess whether the firm's liquidity risk-management function complies with applicable laws, regulations, and sound business practices; and
- report material liquidity risk-management issues in writing to the board of directors or the risk committee for corrective action, to the extent permitted by applicable law.

### *Cash-flow projections*

Covered BHCs (12 C.F.R. 252.34(e)) and FBOs (12 C.F.R. 252.156(d)) are required to produce cash-flow projections over, at minimum, short- and long-term time horizons. Firms must update short-term projections daily and longer-term projections at least monthly. Regulation YY requires firms to establish a methodology for making cash-flow projections that result in projections that meet certain criteria. Firms may adapt the cash-flow projection requirements to their particular circumstances, such as if they have significant broker-dealer activities. More frequent cash-flow reports may be appropriate for firms with complex risk profiles or for all firms during times of stress. Similarly, while cash-flow projections over time horizons longer than one year are not required, it may be appropriate for certain firms to produce cash-flow projections for longer time periods, for instance to account for long-term debt maturities, if circumstances warrant.

### *Contingency funding plan*

As part of a robust regulatory framework to promote comprehensive liquidity risk management, covered firms are required to establish and maintain a contingency funding plan (CFP).

14. In addition, a BHC's senior management and FBO's U.S. risk committee must review at least annually significant business lines and products to determine whether the liquidity risk of each line and product is within the firm's liquidity risk tolerance.

As previously discussed, a CFP is a compilation of policies, procedures, and action plans for managing liquidity stress events that, together, provide a plan for responding to a liquidity crisis. The CFP must be commensurate with the firm’s capital structure, risk profile, complexity, activities, size, and established liquidity risk tolerance. Regulation YY requires a firm’s implementation of its CFP to include quantitative assessments, liquidity event-management processes, monitoring, and testing.

*Liquidity risk limits*

Category I–IV firms are required to monitor sources of liquidity risk and establish limits on liquidity risk that are consistent with their established liquidity risk tolerance and that reflect the firm’s capital structure, risk profile, complexity, and activities.

Category, I, II, and III firms are required to establish and maintain liquidity risk limits that include limits on

- concentrations of funding sources by instrument type, single counterparty, counterparty type, secured and unsecured funding, and other forms of liquidity risk, as applicable;
- the amount of liabilities that mature within various time horizons; and
- off-balance-sheet exposures and other exposures that could create funding needs during liquidity stress events.

*Collateral, legal entity, and intraday liquidity risk monitoring*

Category I–IV firms must establish and maintain procedures for monitoring liquidity risk related to collateral positions, liquidity risks across the enterprise, and intraday liquidity positions. Firms are required to establish and maintain procedures for monitoring

- assets they have pledged as collateral and assets that are available to be pledged, including by calculating and monitoring:
  - collateral positions at specified frequencies,
  - the level of unencumbered assets available to be pledged by legal entity, jurisdiction, and currency exposure,
  - shifts in the firm’s funding patterns, and

- operational and timing requirements associated with accessing collateral;
- liquidity exposures and funding needs within and across significant legal entities, currencies, and business lines, taking into account legal and regulatory restrictions on the transfer of liquidity between legal entities; and
- intraday liquidity risk exposures that are consistent with the firms’ capital structure, risk profile, complexity, activities, and size.

Category I, II, and III firms’ intraday liquidity risk exposure monitoring procedures must address how management will monitor and measure daily liquidity inflows and outflow, manage and transfer collateral to obtain intraday credit, identify and prioritize time-specific payment obligations, manage credit extensions to customers, and consider the amount of collateral and liquidity needed to meet payment systems obligations.

*1060.20.3.1.2 Liquidity Stress Testing and Buffer Requirements*

In addition to requiring firms to establish and maintain robust liquidity risk management, Regulation YY requires large BHCs (12 C.F.R. 252.35) and FBOs (12 C.F.R. 252.157) to conduct internal liquidity stress tests and maintain buffers of highly liquid assets sufficient to meet projected 30-day stressed cash-flow needs under internal stress scenarios. A firm that is subject to Regulation YY must conduct stress tests to assess the potential impact of the liquidity stress scenarios on its cash flows, liquidity position, profitability, and solvency, accounting for its current liquidity condition, risks, exposures, strategies, and activities. Category I, II, and III firms must perform the liquidity stress tests at least monthly, while Category IV firms must perform the liquidity stress tests at least quarterly.<sup>15</sup>

In conducting a liquidity stress test, the firm must address the potential direct adverse impact of associated market disruptions on the firm. Further the firm must incorporate the potential actions of other market participants experiencing liquidity stresses under the market disruptions that would adversely affect the firm. Stress testing should be sufficiently dynamic and incorporate a variety of changes in the firm’s internal position and external circumstances, including risks that may arise over time. Liquidity stress tests must incorporate, at minimum, stress scenarios that reflect adverse market conditions, an

15. 12 C.F.R. 252.35(a)(2) and 252.157(a)(2).

idiosyncratic stress event, and combined market and idiosyncratic stresses. Additional scenarios, based on the firm's financial condition, size, complexity, risk profile, scope of operations, or activities, should be used as needed to ensure that all significant aspects of liquidity risks to the firm have been modeled.

A complementary requirement to the stress testing requirement is a liquidity buffer requirement. Regulation YY requires a firm to maintain a liquidity buffer composed of unencumbered highly liquid assets sufficient to meet projected net stressed cash-flow needs over a 30-day planning horizon (for BHCs and U.S. intermediate holding companies of FBOs) or the first 14 days of a 30-day planning horizon (for U.S. branches and agencies of FBOs) of its internal liquidity stress test. Highly liquid assets included in the liquidity buffer also must meet certain operational and diversification requirements. In particular, a firm must discount the fair market value of the asset to reflect any credit risk and market volatility, establish and implement policies and procedures that require highly liquid assets comprising the buffer be under control of the management function charged with managing liquidity risk, demonstrate the capability to monetize a highly liquid asset under each stress test scenario, and generally ensure the buffer does not contain significant concentrations of highly liquid assets by issuer, business sector, region, or other factor related to the firm's risk.

## 1060.20.4 REGULATION WW (12 C.F.R. PART 249)

The Board's Regulation WW establishes a liquidity coverage ratio (LCR) requirement and net stable funding ratio (NSFR) requirement for certain large firms on a consolidated basis.<sup>16</sup> Firms subject to Regulation WW include

- Global systemically important BHCs;
- Large depository institutions of global systemically important BHCs;
- Category II firms;
- Category III firms; and
- Category IV holding companies with \$50 billion or more in average weighted short-term wholesale funding.

16. Regulation WW applies to certain top-tier BHCs and SLHCs, U.S. intermediate holding companies, and state member banks.

The stringency of LCR and NSFR requirements is tailored based on a firm's category and level of weighted short-term wholesale funding.

### 1060.20.4.1 Liquidity Coverage Ratio Rule

In 2014, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, "the agencies") adopted the LCR rule.<sup>17</sup> The LCR rule is designed to promote the short-term resilience of the liquidity risk profile of large and internationally active banking organizations, thereby improving the banking sector's ability to absorb shocks arising from financial and economic stress, and to further improve the measurement and management of liquidity risk.

The LCR rule implements a quantitative minimum liquidity requirement consistent with the liquidity coverage ratio standard established by the BCBS.<sup>18</sup> Specifically, the LCR rule requires a firm subject to the rule to maintain an amount of high-quality liquid assets (HQLA)—the numerator of the ratio—that is equal to or greater than its total net cash outflows over a prospective 30 calendar-day stress period (the denominator of the ratio).<sup>19</sup>

$$\frac{\text{HQLA amount}}{\text{Net cash outflow amount}} \geq 1.00$$

The Board's Regulation WW (12 C.F.R. part 249) provides more information on calculating the LCR. The LCR complements the liquidity requirements related to firm-specific measures of liquidity risk under the Board's Regulation YY.

#### 1060.20.4.1.1 High-Quality Liquid Assets

HQLA are assets that generally maintain their value in stress and can be easily converted to cash. The LCR rule sets criteria for the category

17. See 79 Fed. Reg. 61,440 (October 10, 2014), codified at 12 C.F.R. part 249.

18. See also [SR-17-11](#), "Interagency Frequently Asked Questions on Implementation of the Liquidity Coverage Ratio (LCR) Rule."

19. The firm's HQLA amount as of the calculation date, calculated under 12 C.F.R. part 249, subpart C. The firm's total net cash outflow amount as of the calculation date, calculated under 12 C.F.R. part 249, subpart D.

ries of assets that qualify as HQLA and divides HQLA into three categories: level 1, level 2A, and level 2B liquid assets.

Level 1 liquid assets include Reserve Bank balances and U.S. Treasury securities, which are the highest quality and most liquid assets. These assets are included in a firm’s HQLA amount without a limit and without haircuts. Level 2A liquid assets include securities issued by U.S. government-sponsored enterprises and are subject to a 15 percent haircut. Level 2B liquid assets include certain debt and equity securities and municipal obligations and are subject to a 50 percent haircut. Level 2A and level 2B liquid assets together may not exceed 40 percent of the total HQLA amount and level 2B liquid assets alone may not exceed 15 percent of the total HQLA amount.

A firm must satisfy certain operational requirements to include an asset that qualifies as HQLA in the firm’s HQLA amount, including that the HQLA be unencumbered, able to be efficiently monetized, and under control of the firm’s liquidity management function. For more information on the qualifying criteria for HQLA and the operational requirements for inclusion in the HQLA amount, see the Board’s Regulation WW.

1060.20.4.1.2 Total Net Cash Outflow Amount

Subpart D of Regulation WW (12 C.F.R. part 249, subpart D) establishes the total net cash outflows (the denominator of the LCR), which is the difference between projected outflows and inflows over a 30 calendar-day period, with an adjustment to address mismatches in timing of outflows and inflows. Inflow amounts cannot offset more than 75 percent of total outflow amounts. A firm must determine outflow and inflow amounts by applying a standardized set of outflow and inflow rates to various asset and liability balances, together with certain off-balance-sheet commitments. These standardized outflow and inflow rates reflect the likelihood of an outflow or inflow in a time of stress. The LCR rule requires firms to employ standardized maturity assumptions to determine whether an outflow or inflow amount occurs within the 30 calendar-day period following the calculation date. To address the risk that a firm’s outflows may mature before its inflows, a firm must include in its total net cash outflow amount a

maturity mismatch add-on, which is calculated as the difference (if greater than zero) between the firm’s largest net cumulative maturity outflow amount for any of the 30 calendar days following the calculation date and the net day 30 cumulative maturity outflow amount.

1060.20.4.1.3 Adjustment Percentage

The stringency of the LCR rule’s minimum requirement is tailored to a firm’s risk profile. The LCR rule calibrates a firm’s minimum LCR requirement by multiplying the net cash outflow amount by an adjustment percentage based on the firm’s category of standards and degree of reliance on short-term wholesale funding. Category I and II firms as well as Category III firms with \$75 billion or more in average weighted short-term wholesale funding are subject to the full LCR requirement. Other Category III firms and Category IV holding companies with \$50 billion or more in average weighted short-term wholesale funding are subject to reduced LCR requirements (adjustment percentages of 85 and 70 percent, respectively). See table 1 below for information on how the adjustment percentage is determined for these firms.

Table 1. Adjustment percentage

Type of firm	Percentage
Global systemically important BHC or G-SIB depository institution	100%
Category II firm	100%
Category III firm with \$75 billion or more in average weighted short-term wholesale funding and any Category III firm that is a consolidated subsidiary of such a Category III firm	100%
Category III firm with less than \$75 billion in average weighted short-term wholesale funding and any Category III firm that is a consolidated subsidiary of such a Category III firm	85%
Category IV holding company with \$50 billion or more in average weighted short-term wholesale funding	70%

#### 1060.20.4.1.4 LCR Shortfall Remediation

Under certain circumstances, a firm's LCR might temporarily fall below 1.0. Given the range of reasons a firm's LCR could fall below 1.0 (for example, the firm might temporarily fall below 1.0 during a period of extreme liquidity stress), Regulation WW establishes a framework for a flexible supervisory response percent to address a firm's LCR shortfall. A firm must notify the appropriate federal banking agency on any business day that its LCR is calculated to be less than its minimum requirement (12 C.F.R. 249.40). In addition, if a firm's LCR is below 1.0 for three consecutive business days, the firm must submit to its appropriate federal banking agency a plan for remediation of the shortfall.<sup>20</sup> These procedures are intended to enable supervisors to monitor and respond appropriately to the unique circumstances that give rise to a firm's LCR shortfall.

#### 1060.20.4.2 Net Stable Funding Ratio Rule

In 2021, the OCC, Board, and the FDIC adopted the NSFR rule.<sup>21</sup> The NSFR rule is designed to reduce the likelihood that disruptions to a firm's regular sources of funding will compromise its liquidity position, promote effective liquidity risk management, and support the ability of firms to continue to lend to businesses and households across a range of market conditions.

The NSFR requires large firms to maintain a minimum level of stable funding based on the liquidity characteristics of the firm's assets, commitments, and derivative exposures. The NSFR rule requires a firm to calculate a weighted measure of the stability of its equity and liabilities over a one-year time horizon, known as its available stable funding amount (numerator of the ratio).<sup>22</sup> A firm also is required to calculate a minimum level of required stable funding, known as its required stable funding amount, based on the liquidity characteristics of its assets, derivative exposures, and commitments over the same one-year time horizon (denominator of the ratio).<sup>23</sup>

Firms subject to the rule are required to keep their ratio of available stable funding to required stable funding equal to at least 1.0 on an ongoing basis.

$$\frac{\text{Available stable funding amount}}{\text{Required stable funding amount}} \geq 1.00$$

Consistent with the LCR rule, the NSFR rule calibrates a firm's minimum NSFR requirement by multiplying the required stable funding amount by an adjustment percentage based on the firm's category of standards and degree of reliance on short-term wholesale funding.<sup>24</sup> See [table 1](#) for information on how the adjustment percentage is determined for these firms. The Board's Regulation WW (12 C.F.R. part 249) provides more information on calculating the NSFR. The NSFR complements the LCR rule, which focuses on short-term liquidity risks, and the firm-specific measures of funding risk under the Board's Regulation YY.

##### 1060.20.4.2.1 NSFR Numerator — Available Stable Funding Amount

A firm's available stable funding amount measures the stability of its regulatory capital elements and liabilities. The available stable funding amount equals the sum of the carrying values of the firm's NSFR regulatory capital elements and NSFR liabilities, in each case multiplied by the available stable funding factor applicable.<sup>25</sup> The available stable funding factor represents the extent to which the capital element or liability is considered available for use by the firm over a one-year time horizon. The available stable funding factors are scaled from zero (least stable) to 100 percent (most stable) and were determined by taking into account the tenor of the funding, type of funding, and type of counterparty. See [table 2](#) for more information on the available stable funding factor assignments.

20. During the period when a firm is required to calculate its LCR monthly, the firm must promptly consult with the appropriate federal banking agency to determine whether a plan would be required if the firm's LCR is below the minimum requirement for any calculation date that is the last business day of the calendar month.

21. 86 Fed. Reg. 9,120 (Feb. 11, 2021).

22. Calculated pursuant to 12 C.F.R. 249.103, as of the calculation date.

23. Calculated pursuant to 12 C.F.R. 249.105, as of the calculation date.

24. 12 C.F.R. 249.105(b).

25. "Carrying value" is the value of an asset, liability, or regulatory capital element on a banking organization's balance sheet as determined in accordance with U.S. Generally Accepted Accounting Principles.

Table 2. Summary of available stable funding factors

Available stable funding factor	Equity and liabilities assigned the available stable funding factor
100%	<ul style="list-style-type: none"><li>• Regulatory capital elements and liabilities with a remaining maturity of one year or more.</li></ul>
95%	<ul style="list-style-type: none"><li>• Fully insured stable retail deposits.</li><li>• Certain fully insured affiliate sweep deposits.</li></ul>
90%	<ul style="list-style-type: none"><li>• Retail deposits that are neither fully insured stable retail deposits nor retail brokered deposits.</li><li>• Certain more stable retail brokered deposits.</li><li>• Non-fully insured affiliate sweep deposits.</li></ul>
50%	<ul style="list-style-type: none"><li>• Unsecured wholesale funding and secured funding transactions with a remaining maturity of less than one year that are provided by wholesale customers that are not financial sector entities or central banks.<sup>1</sup></li><li>• Unsecured wholesale funding and secured funding transactions with a remaining maturity of six months or more, but less than one year and that are provided by financial sector entities or central banks.</li><li>• Securities issued by a banking organization with a remaining maturity of six months or more but less than one year.</li><li>• Operational deposits received by a banking organization.</li><li>• Certain retail brokered deposits with intermediate stability.</li><li>• Retail funding that is not a deposit or security.</li><li>• Any liability with a remaining maturity of six months or more but less than one year that is not described above.</li></ul>
0%	<p>All other funding not described above, including</p> <ul style="list-style-type: none"><li>• Funding (other than operational deposits) where the counterparty is a financial sector entity or a central bank, and the transaction matures within six months.</li><li>• Retail brokered deposits that are not stable.</li><li>• Derivatives liabilities.</li><li>• Trade date payables.</li></ul>

1. Wholesale customers or counterparties that are not financial sector entities or central banks include sovereigns, certain multilateral development banks, public sector entities, and U.S. government-sponsored entities.

Note: See 12 C.F.R. 249.104.

1060.20.4.2.2 NSFR Denominator —  
Required Stable Funding Amount

A firm’s required stable funding amount, the denominator of the NSFR, is based on the liquidity characteristics of the firm’s assets, commitments, and derivative exposures. The required stable funding amount is the sum of the required stable funding amount for non-derivative assets and commitments and the required stable funding amount for derivative transactions.

A firm determines its required stable funding amount for non-derivative assets and commitments by

1. multiplying the carrying value of each asset and commitment by a required stable funding factor, and
2. summing these amounts.

The required stable funding factors are scaled from zero (most liquid and least likely to need ongoing funding during the one-year time horizon) to 100 percent (least liquid and most likely to need ongoing funding during the one-year time horizon) and were determined by taking into account the non-derivative assets’ and commitments’ tenor, credit quality, type of counterparty, market liquidity, and encumbrances. See [table 3](#) for more information on required stable funding factor assignments.

Table 3. Summary of required stable funding factors excluding derivative calculations

Required stable funding factor	Assets and commitments assigned the required stable funding factor
0%	<ul style="list-style-type: none"> <li>Reserve Bank balances or other claims on a Reserve Bank that mature within six months.</li> <li>Claims on a foreign central bank that mature within six months.</li> <li>Currency, coin, and items in the process of collection.</li> <li>Trade date receivables.</li> <li>Level 1 liquid asset securities, including U.S. Treasury securities.</li> <li>Secured lending transactions (e.g., reverse repurchase transactions) where the counterparty is a financial sector entity that mature within six months and are secured by level 1 liquid assets.</li> </ul>
5%	<ul style="list-style-type: none"> <li>The undrawn amount of committed credit and liquidity facilities.</li> </ul>
15%	<ul style="list-style-type: none"> <li>Level 2A liquid assets, including certain obligations issued or guaranteed by a U.S. government sponsored enterprise.</li> <li>Secured lending transactions where the counterparty is a financial sector entity that mature within six months and are secured by assets other than level 1 liquid assets.</li> <li>Unsecured wholesale lending that matures within six months and the counterparty is a financial sector entity.</li> </ul>
50%	<ul style="list-style-type: none"> <li>Level 2B liquid assets, including certain publicly traded corporate equity and debt securities and certain U.S. municipal obligations.</li> <li>Secured lending transactions and unsecured wholesale lending that mature in six months or more, but less than one year, where the counterparty is a financial sector entity or central bank.</li> <li>Secured lending transactions and unsecured wholesale lending that mature in less than one year, where the counterparty is not a financial sector entity or central bank.</li> <li>Lending to retail customers or counterparties that matures in less than one year.</li> <li>Operational deposits placed by a banking organization at financial sector entities.</li> <li>All other assets that mature in less than one year.</li> </ul>
65%	<ul style="list-style-type: none"> <li>Retail mortgages with a remaining maturity of one year or more that are assigned a risk weight of no greater than 50 percent under the Board's capital regulations.</li> <li>Other lending that has a remaining maturity of one year or more, is assigned a risk weight of no greater than 20 percent under the Board's capital regulations, and where the borrower is not a financial sector entity.</li> </ul>
85%	<ul style="list-style-type: none"> <li>Retail mortgages with a remaining maturity of one year or more that are assigned a risk weight of greater than 50 percent under the Board's capital regulations.</li> <li>Other lending that has a remaining maturity of one year or more and is assigned a risk weight greater than 20 percent under the Board's capital regulations, where the borrower is not a financial sector entity.</li> <li>Publicly traded common equity shares that are not HQLA.</li> <li>Other securities that are not HQLA and have a remaining maturity of one year or more.</li> <li>Commodities for which derivative transactions are traded on a U.S. designated contract market, U.S. swap execution facility, or an exchange located outside the United States.</li> </ul>
100%	<p>All other assets not described above, including</p> <ul style="list-style-type: none"> <li>Lending that has a remaining maturity of one year or more, where the borrower is a financial sector entity.</li> <li>Nonperforming assets.</li> <li>Equity securities that are not publicly traded.</li> <li>Commodities that do not qualify to be assigned an 85% required stable funding factor.</li> </ul>

Note: See 12 C.F.R. 249.106.

Derivative transactions present unique risks and generally retain more complex features relative to other assets and liabilities. As such, the NSFR rule requires a firm to calculate the required stable funding amount relating to its derivative transactions separately from its other assets and commitments. The required stable funding amount for a firm's derivatives reflects

- the current net value of the firm's derivatives assets and liabilities, taking into account variation margin provided and received (current net value component);
- contributions by the firm to a central counterparty's default fund in connection with cleared derivative transactions and initial margin provided by the firm pursuant to the derivative transactions (initial margin component); and
- potential changes in the value of the firm's derivative transactions (future value component).

See 12 C.F.R. 249.107 for more information on the calculation of the required stable funding amount for derivatives.

1060.20.4.2.3 NSFR Shortfall Remediation

If a firm has an NSFR shortfall, a firm is required to notify the appropriate federal banking agency of the shortfall within 10 business days. In addition, the NSFR rule requires a firm to develop a remediation plan that would be submitted to the appropriate federal banking agency. The agencies have flexibility in providing a supervisory response to address an NSFR shortfall, which should consider the circumstances of a particular case. In general, the agencies support a firm that chooses to reduce its NSFR during a liquidity stress period in order to continue to lend and undertake other actions to support the broader economy in a safe and sound manner.

1060.20.5 LIQUIDITY REPORTING

Federal Reserve supervision staff use data reported on the FR 2052a, "Complex Institution Liquidity Monitoring Report," to monitor the overall liquidity profile of large firms supervised by the Board. The FR 2052a is required to be submitted by top-tier BHCs, top-tier SLHCs, and FBOs subject to Category I, II, III, or IV

standards under the Board's Regulation YY and Regulation LL. The FR 2052a is required to be submitted at the following frequencies:

- For U.S. firms, firms that are identified as
  - o (1) Global systemically important bank holding companies, (2) Category II banking organizations, or (3) Category III banking organizations and have average weighted short-term wholesale funding of \$75 billion or more must submit a report *on each business day*; and
  - o (1) Category III banking organizations and have average weighted short-term wholesale funding of less than \$75 billion, or (2) Category IV banking organizations must submit a report *monthly*.
- For FBOs, FBOs that are categorized based on the risk profile of their combined U.S. operations as
  - o (1) Category II FBOs, or (2) Category III FBOs with average weighted short-term wholesale funding of \$75 billion or more must submit a report *on each business day*; and
  - o (1) Category III FBOs with average weighted short-term wholesale funding of less than \$75 billion, or (2) Category IV FBOs must submit a report *monthly*.

Data from the FR 2052a provide detailed information on the liquidity risks within different business lines (for example, financing of securities positions, prime brokerage activities). FR 2052a data assist Federal Reserve supervision staff in monitoring compliance with the LCR rule and NSFR rule. The data serve as part of the Federal Reserve's liquidity risk-management supervisory surveillance program and provide timely information on firm-specific liquidity risks during periods of stress. The Board uses analyses of systemic and idiosyncratic liquidity risk to inform its supervisory processes, including the preparation of analytical reports that detail funding vulnerabilities. As the information required by the FR 2052a is collected as part of the Board's supervisory process, such information is entitled to confidential treatment.<sup>26</sup>

26. See exemption 8 of the Freedom of Information Act (FOIA) (5 U.S.C. 552(b)(8)).

1060.20.6 Table 4. Overview of liquidity requirements for domestic and foreign banking organizations

Requirement	C.F.R. reference(s)	Category I	Category II	Category III	Category IV
Liquidity risk management	12 C.F.R. 252.34 12 C.F.R. 252.156	Full set of liquidity risk-management requirements	Full set of liquidity risk-management requirements	Full set of liquidity risk-management requirements	Tailored liquidity risk-management
Liquidity stress tests	12 C.F.R. 252.35 12 C.F.R. 252.157	At least <b>monthly</b>	At least <b>monthly</b>	At least <b>monthly</b>	At least <b>quarterly</b>
Liquidity coverage ratio (LCR)	12 C.F.R. 249.10h	Full <b>daily</b> LCR (100%)	Full <b>daily</b> LCR (100%)	If \$75 billion or more in weighted short-term wholesale funding (wSTWF), full <b>daily</b> LCR (100%) If less than \$75 billion in wSTWF, reduced <b>daily</b> LCR (85%)	If \$50 billion or more in wSTWF, reduced <b>monthly</b> LCR (70%) If less than \$50 billion in wSTWF, <b>no LCR requirement</b>
Net stable funding ratio (NSFR)	12 C.F.R. 249.100	Full NSFR (100%)	Full NSFR (100%)	If \$75 billion or more in wSTWF, full NSFR (100%) If less than \$75 billion in wSTWF, reduced NSFR (85%)	If \$50 billion or more in wSTWF, reduced NSFR (70%) If less than \$50 billion in wSTWF, <b>no NSFR requirement</b>
Liquidity reporting (FR 2052a)		<b>Daily</b> T+2 FR 2052a reporting	<b>Daily</b> T+2 FR 2052a reporting	If wSTWF ≥ \$75b: <b>Daily</b> T+2 FR 2052a reporting If wSTWF < \$75b: <b>Monthly</b> T+2 FR 2052a reporting	<b>Monthly</b> T+10 FR 2052a reporting

Note: Certain requirements for a foreign bank are determined by the risk profile of its intermediate holding company, whereas other requirements are determined by the risk profile of the firm's combined U.S. operations. Standardized liquidity requirements are determined by the risk profile of the intermediate holding company and other liquidity requirements are determined by the risk profile of the foreign bank's combined U.S. operations. Other foreign banks with limited U.S. presence and global assets of \$100 billion or more would be subject to certain minimum liquidity risk-management requirements.

1060.20.7 SUPERVISORY  
CONSIDERATIONS FOR ASSESSING  
LIQUIDITY

Through the supervisory process, the Federal Reserve assesses a firm’s compliance with liquidity regulations and ability to manage liquidity risk. The Federal Reserve has issued the “Consolidated Supervision Framework for Large Financial Institutions,” which describes the supervisory framework for the consolidated supervision of large U.S. and foreign financial institutions.<sup>27</sup>

The consolidated supervision framework for large financial institutions has two primary objectives: (1) to enhance the resiliency of a firm to lower the probability of its failure or an inability to serve as a financial intermediary and (2) to reduce the effect on the financial system and the broader economy of a firm’s failure or material weakness.

The consolidated supervision framework guidance outlines expectations for effective liquidity planning for large financial institutions. To support effective liquidity planning and adequate liquidity positions, a firm should

- maintain strong liquidity positions that not only comply with regulatory requirements, but also support the firm’s ongoing ability to meet its obligations to creditors and other counterparties, as well as continue to serve as a financial intermediary through periods of stress;
- have in place robust internal processes that enable the firm to maintain liquidity commensurate with its unique risks under normal and stressful conditions;
- maintain processes that enable the identification and measurement of potential risks to cash flows and other primary determinants of liquidity positions;
- utilize comprehensive projections of the level and composition of liquidity resources, supported by regular stress testing to assess the potential impact of a broad range of expected and potentially adverse scenarios;
- maintain sound risk measurement and modeling capabilities, supported by comprehensive

data collection and analysis, independent validation, and effective governance, policies, and controls;<sup>28</sup>

- establish goals for liquidity positions and reflect the potential impact of legal or regulatory restrictions on the transfer of liquidity between legal entities; and
- maintain independent internal audit and other review functions with appropriate staff expertise, experience, and stature in the organization to monitor the adequacy of liquidity risk-measurement and management processes.

1060.20.7.1 Comprehensive Liquidity  
Analysis and Review

The Comprehensive Liquidity Analysis and Review (CLAR) program is an annual horizontal supervisory program for Large Institution Supervision Coordinating Committee (LISCC) firms subject to Federal Reserve System oversight.<sup>29</sup> The purpose of the CLAR program is to assess liquidity risk and evaluate each LISCC firm’s liquidity position and liquidity risk-management practices. The CLAR program is divided into three pillars covering the various topics for assessing each firm’s liquidity position and liquidity risk-management practices.

- Pillar I evaluates a firm’s internal liquidity risk-measurement capabilities and practices. This assessment includes an evaluation of the internal stress testing frameworks used to evaluate a firm’s liquidity position based on that firm’s assumptions.
- Pillar II performs an independent liquidity risk analysis for each firm and measures the liquidity position of a firm using the Federal Reserve’s internal metrics and publicly available models and data. This pillar assesses whether a firm has sufficient liquid assets to match its outflows and an adequate funding structure to decrease the likelihood that disruptions to its regular funding sources will affect that firm’s liquidity position.

27. See SR-12-17/CA-12-14, “Consolidated Supervision Framework for Large Financial Institutions.”

28. See SR-11-7, “Guidance on Model Risk Management.”

29. A horizontal examination is a review of a specific activity, business line, or risk-management practice across a group of firms. Horizontal examinations are conducted to understand the range of industry practices for a specific activity, product, risk-management practice, or control; to ensure the consistent application of established supervisory expectations; and to confirm the consistent assignment of ratings. For more information on the criteria for determining which firms are in the LISCC supervisory program, see SR-20-30, “Financial Institutions Subject to the LISCC Supervisory Program.”

- Pillar III evaluates a firm's liquidity risk management using methods other than internal stress testing. This component of the program informs the overall assessment of each firm's risk-management practices. This pillar, in conjunction with Pillar I, is also responsible for coordinating the completion of any liquidity risk reviews necessary for the Supervisory Assessment of Resolution and Recovery Preparedness.

The results from each pillar contribute to an assessment that includes each firm's final liquidity rating and overall liquidity assessment. Supervisors frequently use these horizontal examinations or reviews on a single topic across several firms to identify risks and common trends. Horizontal reviews may be conducted by a centralized team of examiners or through a common scope or work program executed by the dedicated supervisory teams. Unlike the Comprehensive Capital Analysis and Review, the LISCC liquidity program's assessment does not result in an objection or non-objection. Rather the LISCC liquidity program's assessment results in supervisory findings communicated to the firm, which may include "matters requiring attention" and "matters requiring immediate attention," as applicable.<sup>30</sup>

### 1060.20.7.2 Liquidity Reviews at Large and Foreign Banking Organizations

The Federal Reserve conducts various horizontal reviews to evaluate the adequacy of liquidity positions and the effectiveness of liquidity risk-management practices and liquidity stress testing of firms in the Large and Foreign Banking Organization (LFBO) supervisory portfolio. Additionally, the Federal Reserve completes focused analysis on firms' liquidity positions using data derived from the FR 2052a and other reports to supplement the horizontal reviews. These reviews are tailored to account for differences in the size, complexity, and risk profile among firms.

The Federal Reserve completes an annual Horizontal Liquidity Review (HLR) for the following large firms that are not in the LISCC portfolio:

- domestic firms with \$100 billion or more in total consolidated assets; and
- foreign banking organizations with \$50 billion or more in total consolidated assets.

Similar to the CLAR program, examiners complete forward-looking assessments of liquidity risk management and liquidity positions for firms in the LFBO portfolio. The HLR assessment evaluates similar liquidity risk topics as the CLAR pillars. However, the examination scope and expectations are tailored based on LFBO firms' risk profile, which pose lower systemic risk than LISCC firms. The HLR targets a select number of liquidity risk topics in a given year.

As discussed in this manual's section 1060.0, "Large Financial Institution Rating System," the Federal Reserve assigns a liquidity risk management and positions component rating to each LFBO. The liquidity risk management and positions component rating is not based solely on the outcome of HLR. The full body of related supervisory work and monitoring is considered, including from other regulators, since the previous ratings communication to a firm.

### 1060.20.7.3 Assessment of Liquidity at Firms Covered by the Large Financial Institution Ratings System

Given the Federal Reserve's development of a supervisory program to enhance resiliency and address the risks posed by large financial institutions, the Federal Reserve developed the Large Financial Institution (LFI) rating system to better assess these firms. Under the LFI rating system, examiners assign component ratings for capital planning and positions, liquidity risk management and positions, and governance and controls. Further, examiners assign each rating into one of the following rating categories: Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1, and Deficient-2. For more information on the LFI Rating System see this manual's section 1060.0, "Large Financial Institution Rating System."

### 1060.20.7.4 Assessment of Liquidity at the Depository Institution

The Uniform Financial Institutions Rating System (UFIRS), commonly referred to as the "CAMELS" rating system, establish criteria for rating a bank or thrift, including bank or thrift subsidiaries of holding companies. Under the UFIRS, each depository institution is assigned a composite rating based on an evaluation and rating

30. See [SR-13-13/CA-13-10](#), "Supervisory Considerations for the Communication of Supervisory Findings."

of six essential components of its financial condition and operations. These component factors address the adequacy of capital, quality of assets, capability of management, quality and level of earnings, adequacy of liquidity, and sensitivity to market risk. For more information on the UFIRS, see the [Commercial Bank Examination Manual](#), and “Uniform Financial Institutions Rating System.”<sup>31</sup>

In evaluating the adequacy of a depository institution’s liquidity position, consideration is given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds-management practices relative to the firm’s size, complexity, and risk profile. In general, funds management prac-

tices should ensure that a depository institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the firm to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds-management practices should ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

31. See SR-96-38, “Uniform Financial Institutions Rating System.”

### 1060.30.1 OVERVIEW AND APPLICABILITY

The Federal Reserve expects the board of directors (board) of a large financial institution (LFI) to be effective in its oversight of the firm. The board plays a critical role in maintaining the firm's safety and soundness and continued financial and operational resilience of its consolidated operations. The supervisory assessment of the board's effectiveness is one of the elements within the Governance and Controls component rating of the LFI rating system. In February 2021, the Federal Reserve issued guidance describing the key attributes of effective boards at large domestic bank holding companies and savings and loan holding companies, and systemically important nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve (board effectiveness guidance).

The board effectiveness guidance is intended to promote firms' safety and soundness and compliance with laws and regulations by better distinguishing supervisory expectations for boards from those of senior management and refocusing supervisory expectations on boards' performance of their core responsibilities. The Federal Reserve recognizes that boards can effectively fulfill their core responsibilities in a variety of ways. As such, the board effectiveness guidance adopts a principles-based approach to provide each board with flexibility to determine how to most effectively fulfill its responsibilities. Responsibilities that are typically the purview of senior management, including most daily and operational decisions, are not described in the board effectiveness guidance.

The board effectiveness guidance applies to

- domestic bank holding companies with total consolidated assets of \$100 billion or more;<sup>1</sup>
- domestic savings and loan holding companies with total consolidated assets of \$100 billion or more;<sup>2</sup> and
- systemically important nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve.

1. The guidance does not apply to U.S. intermediate holding companies of foreign banking organizations established pursuant to the Federal Reserve's Regulation YY.

2. This guidance applies to state regulated insurance companies that are also savings and loan holding companies to the extent it does not conflict with state insurance laws or regulatory requirements.

### 1060.30.2 KEY ATTRIBUTES OF AN EFFECTIVE BOARD OF DIRECTORS

The board effectiveness guidance describes the five key attributes of an effective board of directors in overseeing the firm's safe and sound conduct of consolidated operations; compliance with laws and regulations, including those related to consumer protection; and financial and operational strength and resilience necessary to carry out its business activities. The entire board effectiveness guidance is provided in [SR-21-3/CA-21-1](#), "Supervisory Guidance on Board of Directors' Effectiveness."

#### 1060.30.2.1 Set Clear, Aligned, and Consistent Direction Regarding the Firm's Strategy and Risk Appetite

An effective board oversees the development of, reviews, approves, and periodically monitors the firm's strategy and risk appetite.<sup>3</sup> Such a strategy and risk appetite are clear and aligned, and include a long-term perspective on risks and rewards that is consistent with the capacity of the firm's risk-management framework. The alignment of strategy and risk appetite helps the firm to maintain sufficient financial and operational strength and resilience for safety and soundness and to promote compliance with laws and regulations.

A clear strategy articulates a firm's strategic objectives for its businesses, while helping to establish and maintain

1. an effective risk-management structure;
2. appropriate processes and resources for strategy implementation, plans, and budgets for each business line and risk-management or control function; and
3. an effective risk-management and control function.

A clear strategy also provides direction to senior management about how to determine which business opportunities to pursue consis-

3. "Risk appetite" is defined as the aggregate level and types of risk the board and senior management are willing to assume to achieve the firm's strategic business objectives, consistent with applicable capital, liquidity, and other requirements and constraints.

tent with the firm's risk appetite and risk-management capacity.

#### A clear risk appetite

- includes sufficient detail to enable the firm's chief risk officer (CRO) and its independent risk-management function to set firm-wide risk limits.<sup>4</sup>
- specifies the level and types of risk that the board is willing to assume, that the board believes the firm is capable of managing, and that allows senior management to establish risk-management expectations and monitor risk-taking for the full set of risks.

A firm's strategy and risk appetite are aligned when they are developed, reviewed, and approved consistent with one another even though they are not necessarily developed and approved simultaneously.

An effective board also considers the capacity of the firm's risk-management framework when overseeing aspects of the firm's strategy and risk appetite. This practice helps to confirm that strategic plans are commensurate with the firm's ability to identify and manage risks, including identifying activities that could pose a material risk to the safety and soundness of the firm, threaten the financial system, violate the law, or harm consumers.

For example, if the firm is considering a new line of business, a clear strategy explains how conducting the business would be consistent with the firm's risk appetite and changes that would need to be made to the firm's risk-management program and its controls to effectively manage different or additional risks posed by the new business. If the strategy calls for expansion into a new line of business or a new jurisdiction, the board evaluates the increased level of risk. In addition, an effective board reviews any corresponding risk management or controls enhancements, including those related to compliance with U.S. laws, that are necessary to align with the risk appetite.<sup>5</sup> The same evalu-

ation is conducted on a regular basis to assess growth strategies within current businesses and products.

A firm's policies, programs, and plans are sufficiently clear regarding the allocation of responsibilities to enable the board to evaluate senior management's execution of the firm's strategic plan. An effective board reviews and approves significant policies, programs, and plans based on the firm's strategy, risk appetite, risk-management capacity, and structure. These include but are not limited to the firm's

- capital plan,<sup>6</sup>
- recovery and resolution plans,<sup>7</sup>
- audit plan,<sup>8</sup>
- enterprise-wide risk-management policies,<sup>9</sup>
- liquidity risk-management policies,<sup>10</sup>
- compliance risk-management program,<sup>11</sup> and
- performance management and compensation programs.

An effective board might review summarized forms of policies, programs, and plans, with the summarized form including sufficient detail and context for the board to make an informed decision and to consider consistency with the firm's strategy, risk appetite, and risk-management capacity.

### 1060.30.2.2 Direct Senior Management Regarding the Board's Information Needs

An effective board directs senior management to provide directors with information that is sufficient in scope, detail, and analysis to enable

6. 12 CFR 225.8(e)(iii); 12 CFR 252.47(a); [SR-15-19](#), "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category II or III Standards;" [SR-15-18](#), "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Firms Subject to Category I Standards;" and Federal Reserve paper on *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice* (Federal Reserve Board press release issued on August 19, 2013).

7. 12 CFR part 243; [SR-14-8](#), "Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies;" and [SR-14-1](#), "Heightened Supervisory Expectations for Recovery and Resolution Preparedness for Certain Large Bank Holding Companies - Supplemental Guidance on Consolidated Supervision Framework for Large Financial Institutions ([SR-12-17/CA-12-14](#))."

8. [SR-13-1/CA-13-1](#), "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing," and [SR-03-5](#), "Amended Interagency Guidance on the Internal Audit Function and its Outsourcing."

9. 12 CFR 252.33.

10. 12 CFR 252.34(a).

11. [SR-08-8/CA-08-11](#), "Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles."

4. An "independent risk-management function" is responsible for identifying, measuring, aggregating, and reporting risks in a comprehensive and independent manner. The term "risk limits" refers to thresholds that constrain risk-taking so that the level and type of risks assumed remains consistent with the firm-wide risk appetite. Internal risk management sets risk limits in aggregate by concentration and risk type, as well as at more granular levels as appropriate.

5. U.S. laws include, without limitation, the Bank Secrecy Act and the Foreign Corrupt Practices Act.

the board to make sound, well-informed decisions and consider potential risks.

An effective board directs senior management to provide it with information that is timely, accurate, and well organized. An effective board also evaluates the sufficiency and quality of information it receives and directs senior management to

1. provide more information;
2. address any concerns regarding the volume, structure, content, or quality of the information it receives; or
3. improve relevant firm processes and practices for the preparation of such information.

An effective board seeks, outside of regular board and committee meetings, information about the firm and its activities, emerging and ongoing risks, personnel, compensation, and other matters. Such additional inquiries are often conducted through special sessions of the board, outreach to staff other than the Chief Executive Officer (CEO) and their direct reports, and discussions with Federal Reserve senior supervisors. Director training is another way directors may learn more about topics relevant to their responsibilities and may highlight the need for further director inquiries.

Directors of an effective board, particularly the lead independent director or independent board chair and committee chairs, take an active role in setting board and committee meeting agendas. Directors provide input such that the content, organization, and time allocated to each topic allow the board and committees to make sound, well-informed decisions. If the board's agenda includes a discussion of growth into a new business, an effective board typically discusses the firm's risk management and control capabilities that reflect the views of the independent risk-management and internal audit functions.

### 1060.30.2.3 Oversee and Hold Senior Management Accountable

An effective board oversees and holds senior management accountable for effectively implementing the firm's strategy, consistent with its risk appetite, while maintaining an effective risk-management framework and system of internal controls. An effective board executes these responsibilities consistent with safety and soundness and in compliance with laws and regulations, including those related to consumer protection, under a range of conditions. An

effective board also oversees and regularly evaluates the performance and compensation of senior management.

To facilitate accountability, an effective board engages senior management in a variety of ways. For instance, at board meetings, engagement is supported by allocating sufficient time to facilitate a candid discussion and debate of information while encouraging diverse views. Directors consider whether and how senior management's conclusions and recommendations align and support the firm's strategy and risk appetite. If weaknesses or gaps are identified, the information provided is incomplete, or as otherwise warranted, directors challenge senior management's assessments and recommendations. Engagement may also take place outside board and committee meetings.

An effective board engages in robust inquiry into, among other things,

- drivers, indicators, and trends related to current and emerging risks;
- adherence to the board-approved strategy and risk appetite by relevant lines of business; and
- material or persistent deficiencies in risk management or control practices, whether in policy or in practice.

An effective board also reviews reports of internal and external complaints, including "whistleblower" reports.

An effective board has independent directors who are sufficiently empowered to serve as an effective check against firm executives who sit on the board and against senior management. For example, if the board has an executive chair, independent directors may be empowered through the election of a lead independent director with the authority, among others, to call board meetings with or without the chair present.

A crucial aspect of holding senior management accountable is regular board oversight and evaluation of the performance and compensation of senior management. An effective board oversees and evaluates the development and implementation of performance management and compensation programs that encourage behaviors and business practices consistent with the firm's strategy, risk appetite, and safety and soundness. This includes promoting compliance with laws and regulations, including those related to consumer protection.

In addition, each component of senior management's total compensation is informed by

the board's evaluation of the individual's performance against performance objectives. An effective board approves clear financial and nonfinancial performance objectives aligned with the firm's strategy and risk appetite for the CEO and business line executives and nonfinancial performance objectives for the CRO and chief audit executive. Similar performance objectives are developed for other members of senior management. An effective board of directors also holds senior management accountable for the implementation of performance management and compensation programs that promote sound risk management: compliance with laws and regulations; and internal standards, including for conduct. Performance management and compensation programs, when combined with business strategies, discourage risk-taking inconsistent with the firm's strategy and safety and soundness, including compliance with laws, regulations, and internal standards, and promote the firm's risk-management goals. Consistent with safety and soundness, compliance with laws and regulations, and the firm's strategy, an effective board oversees succession plans for the CEO, and depending on the size, complexity, and nature of the firm, the CRO, chief audit executive, or other senior management officials.<sup>12</sup>

#### 1060.30.2.4 Support the Independence and Stature of Independent Risk Management and Internal Audit

An effective board of directors, through its risk and audit committees, assesses and supports the stature and independence of the firm's independent risk-management and internal audit functions. An effective risk committee and an effective audit committee engage in robust inquiry into, among other matters,<sup>13</sup>

- the causes and consequences of material or persistent breaches of the firm's risk appetite and risk limits,
- the timeliness of remediation of material or persistent internal audit and supervisory findings, and
- the appropriateness of the annual audit plan.

An effective risk committee supports the stature and independence of the independent risk-management function by:

- communicating directly with the CRO on material risk-management issues;
- overseeing the appropriateness of independent risk management function's budget, staffing, and systems of internal controls;
- coordinating with the compliance function; and
- providing the independent risk management function with direct and unrestricted access to the risk committee.<sup>14</sup>

After reviewing the risk-management framework relative to the firm's structure, risk profile, complexity, activities, and size, an effective risk committee effects changes that align with the firm's strategy and risk appetite.

An effective audit committee

- supports the stature and independence of internal audit by meeting directly with the chief audit executive regarding the internal audit function, organizational concerns, and industry concerns.
- supports internal audit's budget, staffing, and systems of internal controls relative to the firm's asset size, complexity, and the pace of technological and other changes.
- reviews the status of actions recommended by internal audit and external auditors to remediate and resolve material or persistent deficiencies identified by internal audit, external audit, and findings identified by supervisors.

An effective board monitors the independence and stature of independent risk management and internal audit and takes action if the views of these functions are not taken into

12. This may extend beyond requirements to which firms may be subject under other statutory and regulatory authorities. For example, the NYSE requires formalized succession planning for the CEO only. See NYSE Listed Company Manual, section 303A.09. The CRO and chief audit executive are named here given the independence of those positions and the control function each serves.

13. The risk committee is responsible for the firm's global risk-management policies and oversight of the firm's global risk-management framework. 12 CFR 252.33(a). Nonbank financial companies supervised by the Federal Reserve are required to establish a risk committee pursuant to section 165 of the Dodd-Frank Act. 12 U.S.C. 5365(h)(1). Savings and loan holding companies subject to this guidance should maintain a risk committee that meets the supervisory expectations discussed herein in order to enhance its safety and soundness.

Also, see [SR-13-1/CA-13-1](#). Firms that are publicly traded are subject to the audit committee requirements contained in the U.S. Securities and Exchange Commission's Rule 10A-3 ("Rule 10A-3") under the Exchange Act of 1934, in addition to any requirements imposed by the applicable stock exchange on which the firm is listed. See, for example, NYSE Listed Company Manual, sections 303A.06 and 303A.07, and the Nasdaq Stock Market Rules, section 5605(c).

14. See, e.g., 12 CFR 252.33(a)(3).

account when decisions are made, or if these functions are unduly influenced by business lines.

### 1060.30.2.5 Maintain a Capable Board Composition and Governance Structure

An effective board considers whether its composition, governance structure, and practices support the firm's safety and soundness and the ability to promote compliance with laws and regulations based on factors such as the firm's asset size, complexity, scope of operations, risk profile, and other changes that occur over time. Reflecting these factors, an effective board establishes a process designed to identify and select potential director nominees with a mix of skills, knowledge, experience, and perspectives. This process takes into account, for example, a potential nominee's expertise, availability, integrity, and potential conflicts of interest and considers a diverse pool of potential nominees, including women and minorities.<sup>15</sup>

An effective board maintains a governance structure capable of overseeing senior management and addressing issues arising from the firm's size, scope of operations, activities, risk profile, and resolvability. In addition, an effective board establishes committees and management-to-committee reporting lines to support effective oversight, timely access to information, and sound decisionmaking. An effective board also has the capacity to engage third-party advisors and consultants, when appropriate, to supplement the board's knowledge, expertise, and experience and support the board in making sound, well-informed decisions.

An effective board evaluates on an ongoing basis its strengths and weaknesses, including the performance of the board committees, particularly the risk, audit, and other key committees. An effective board adapts its structure and practices to address identified weaknesses or deficiencies and as the firm's asset size, scope of operations, risk profile, and other characteristics change over time.

## 1060.30.3 SUPERVISORY CONSIDERATIONS IN ASSESSING BOARD EFFECTIVENESS

The board effectiveness guidance emphasizes the key aspects of board responsibilities and clarifies how supervisors assess board oversight. As the board effectiveness guidance builds on the principles set forth in the LFI ratings framework, the Federal Reserve uses the board effectiveness guidance to inform its assessment of the governance and controls for all firms to which the guidance applies. In addition to the board effectiveness guidance, the Federal Reserve considers applicable statutes, regulations, and guidance on specific risks or business activities.

Federal Reserve supervisory staff should base their assessment of board effectiveness on supervisory work that may include

- engaging directly with directors in meetings or other venues on how a board's structures and practices reflect the key attributes of an effective board. For example, the Federal Reserve supervisory staff may inquire as to how the board achieves the proper alignment of its strategy with its risk appetite;
- obtaining and reviewing information that the directors receive, including escalated issues, board packages, findings, and internal reports;
- meeting with firm management and other personnel;
- evaluating publicly available information as well as information obtained from examinations conducted by the Federal Reserve or other federal or state financial supervisors that relate to the expectations for boards;<sup>16</sup> and
- communicating with directors at firms with significant supervisory issues outside of board meetings (including meetings of the audit or risk committees) on a more frequent basis.

Ratings assigned under the LFI rating system are communicated by the Federal Reserve to the firm, but individual ratings are not disclosed

15. "Final Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies," 80 Fed. Reg. 33,016 (June 10, 2015). The use of the term "minority" is consistent with the use of such term in this interagency policy statement and in section 342(g)(3) of the Dodd-Frank Act.

16. In assessing board effectiveness for insurance savings and loan holding companies, the Federal Reserve tailors its supervisory expectations based on each firm's size, risk profile, complexity, organizational structure, business model, and information gathered and assessments obtained from each firm's primary functional state insurance regulators and other functional regulators. The Federal Reserve relies, to the greatest extent possible, on the work and examination reports of state insurance regulators for its assessment of state regulated insurance companies within an insurance savings and loan holding companies' structure.

publicly. The Federal Reserve assigns LFI ratings and communicates ratings to large firms on an annual basis and more frequently as warranted.

Examiners will not criticize—through the issuance of “matters requiring attention” in an examination report or supervisory letter—a supervised financial institution for, and the Board

will not issue an enforcement action on the basis of, a “violation” of or “non-compliance” with supervisory guidance, such as the board effectiveness guidance. However, in some situations, examiners may provide a written reference to the board effectiveness guidance in examination reports or supervisory letters to provide examples of safe and sound conduct.<sup>17</sup>

17. See 12 CFR part 263, appendix A.

# Assessment of Risk-Management Processes and Internal Controls of BHCs Having \$100 Billion or More in Total Assets

## Section 1060.31

### 1060.31.1 GOVERNANCE AND CONTROLS RATING AND APPLICABILITY

As described in section 1060.0, the “Governance and Controls” component rating of the Large Financial Institutions (LFI) rating system reflects Federal Reserve supervisory staff’s evaluation of the effectiveness of a firm’s (1) board of directors, (2) management of business lines and independent risk management and controls, and (3) recovery planning (for domestic Large Institution Supervision Coordinating Committee firms only). This component rating represents the Federal Reserve’s supervisory assessment of a firm’s effectiveness in aligning strategic business objectives with the firm’s risk appetite and risk-management capabilities; maintaining effective and independent risk-management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise providing for the ongoing resiliency of the firm.

This section provides guidance for examiners in the assessment of risk management, processes, and internal controls of bank holding companies that have \$100 billion or more in total assets. The supervisory assessment of a state member bank’s risk management would be reflected in the management component (M) of the CAMELS rating framework as well as the Risk Management rating. For information on the CAMELS rating framework, refer to the Federal Reserve’s *Commercial Bank Examination Manual*.

Examiners should recognize that the matters discussed in this section are intended only to assist an examiner in evaluating a firm’s risk-management practices. Therefore, *the information in this section should not be treated as a checklist of requirements for an individual organization*. Moreover, while a bank holding company should be able to assess the major risks of the consolidated organization, examiners should expect a holding company that centrally manages the operations and functions of its subsidiary banks to have more-comprehensive, detailed, and developed risk-management systems than a company that delegates risk management to relatively autonomous banking subsidiaries. For more information, see the “Elements of Risk Management” discussion in [SR-95-51](#), “Rating the Adequacy of Risk Management Pro-

cesses and Internal Controls at State Member Banks and Bank Holding Companies.”<sup>1</sup>

### 1060.31.2 OVERVIEW

The Federal Reserve places significant supervisory emphasis on the importance of a bank holding company’s sound risk-management processes and strong internal controls when evaluating the activities of a supervised financial institution. A bank holding company’s failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business has long been considered unsafe and unsound conduct. Serious lapses or deficiencies in a bank holding company’s internal controls, including inadequate separation of duties, can constitute an unsafe and unsound practice and possibly lead to significant losses or otherwise compromise the financial integrity of the institution.<sup>2</sup> Accordingly, while a bank holding company’s financial performance is an important indicator of the adequacy of management, examiners should give significant weight to the quality of risk-management practices and internal controls when they evaluate the management and overall financial condition of bank holding companies. Properly managing risks is even more important as new technologies, product innovation, and the size and speed of financial transactions change the nature of banking markets.

1. Since the issuance of SR-95-51, the Federal Reserve revised the supervisory ratings frameworks for holding companies. Therefore, refer to this manual’s sections entitled, “Large Financial Institution Rating System,” ([SR-19-3/CA-19-2](#)) and “RFI Rating System,” ([SR-19-4/CA-19-3](#)) for the supervisory ratings frameworks used for holding companies. The Risk Management rating, as described in SR-95-51, applies to all state member banks, regardless of their size. For more information on the Risk Management rating criteria and CAMELS ratings framework, see the *Commercial Bank Examination Manual*.

2. If appropriate, the institution should be advised that the Federal Reserve will initiate supervisory actions if its failure to separate critical operational duties creates the potential for serious losses or if material deficiencies or situations that threaten the safe and sound conduct of its activities are not adequately addressed in a timely manner. Such supervisory actions may include formal enforcement actions against the bank or bank holding company, or its responsible officers and directors, or both, and would require the immediate implementation of all necessary corrective measures.

The principles of sound management should apply to the entire spectrum of risks which include, but are not limited to, credit, market, liquidity, operational, legal, and reputational risk:

- **Credit risk** arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- **Market risk** is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.
- **Liquidity risk** is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions ("market liquidity risk").
- **Operational risk** arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- **Legal risk** arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization.
- **Reputational risk** is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

The supervisory assessment of a firm's risk-management process is designed to bring together and summarize much of the analysis of and many of the findings about a bank holding company's process for managing and controlling risks. This assessment is intended to highlight and incorporate both the quantitative and qualitative aspects of an examiner's review of a firm's overall process for identifying, measuring, monitoring, and controlling risks and to facilitate appropriate follow-up action.

The overall profitability, asset quality, and capital adequacy of a bank holding company should be considered in the examiner's assessment of management. These indicators can to some extent be affected, either favorably or

adversely, by factors outside management's control. For this reason, examiners' evaluation of the risk-management process should be a primary factor when assessing management at larger firms whose activities and structures require more formal and extensive procedures.

### 1060.31.3 ELEMENTS OF RISK MANAGEMENT

When assessing the quality of risk management at bank holding companies, examiners should consider the adequacy, effectiveness, and comprehensiveness of the key elements of a sound risk-management system:

1. roles and responsibilities of board of directors and senior management
2. policies, procedures, and limits
3. risk measurements, risk monitoring, and management information systems
4. internal controls

#### 1060.31.3.1 Board of Directors and Senior Management

In assessing the quality of oversight by the board of directors and senior management, examiners should consider whether the bank holding company follows policies and practices such as those described below:

##### *Board of Directors*

1. The board of directors makes appropriate efforts to remain informed about the risks inherent in the bank holding company's activities.
2. The board of directors reviews and approves significant policies to limit risks inherent in the bank holding company's lending, investing, trading, trust, fiduciary, and other significant activities or products.
3. The board of directors or the responsible committee of the board:
  - a. reviews and approves risk-exposure limits to conform with any changes in the bank holding company's strategies,
  - b. addresses new products, and
  - c. reacts to changes in market conditions.
4. The board of directors holds senior management accountable as financial markets, risk-management practices, and the bank holding company's activities evolve.

### *Senior Management*

1. Senior management has identified and has a clear understanding and working knowledge of the types of risks inherent in the bank holding company's activities.
2. Senior management is sufficiently familiar with and is using adequate recordkeeping and reporting systems to measure and monitor the major sources of risk to the organization.
3. Senior management ensures that its lines of business are managed and staffed by personnel whose knowledge, experience, and expertise are consistent with the nature and scope of the bank holding company's activities.
4. Senior management ensures that the depth of staff resources is sufficient to operate and soundly manage the bank holding company's activities and that its employees have the integrity, ethics, and competence that are consistent with a prudent management philosophy and operating style.
5. Senior management adequately oversees business line management who are responsible for carrying out the institution's day-to-day activities and implementing its strategic plan.
6. Senior management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active.
7. Before embarking on new activities or introducing new products, management identifies and reviews all risks associated with the activity or product and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.

### 1060.31.3.2 Policies, Procedures, and Limits

A bank holding company's board of directors should set clear, aligned, and consistent direction regarding the firm's strategy and risk appetite. The following guidelines should assist examiners in evaluating the adequacy of a bank holding company's policies, procedures, and limits:

1. The bank holding company's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its lending, investing, trading, fiduciary, and other significant activities.

2. The policies, procedures, and limits are consistent with senior management's experience level, the organization's stated goals and objectives, and its overall financial strength.
3. Policies clearly delineate accountability and lines of management authority across the organization's activities.
4. Policies provide for the review of new activities to ensure that the organization's infrastructure is adequate to identify, monitor, and control risks associated with an activity and that the control infrastructure is in place before the activity is initiated.

### 1060.31.3.3 Risk Monitoring Activities and Management Information System

As part of its risk monitoring activities and management information system (MIS), a firm should be able to identify and measure all material risk exposures. Therefore, a firm's MIS should be able to provide senior management and board of directors with timely reports on the financial condition, operating performance, and risk exposure of the consolidated organization. Further, the MIS should be able to provide regular and sufficiently detailed reports for line managers engaged in the organization's day-to-day activities.

In assessing the adequacy of a bank holding company's measurement and monitoring of risk and the adequacy of its MIS, examiners should consider whether the following conditions exist:

1. The bank holding company's risk-monitoring practices and reports address material risks.
2. Key assumptions, data sources, and procedures used in measuring and monitoring risks are appropriate and adequately documented and tested for reliability on an ongoing basis.
3. Reports and other forms of communication are consistent with the bank holding company's activities; are structured to monitor exposures and compliance with internal limits, goals, or objectives; and, as appropriate, compare actual versus expected performance.
4. Reports to senior management or the board of directors are accurate and timely and contain sufficient information for decision makers to identify any adverse trends and to adequately evaluate the level of a firm's risk exposure.

### 1060.31.3.4 Internal Controls

A bank holding company's internal control structure is critical to promoting safe-and-sound operations and an effective risk-management system. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate separation of duties—such as trading, custodial, and back-office—is one of management's more important responsibilities.

Appropriate segregation of duties is a fundamental and essential element of a sound risk-management and internal control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice and possibly lead to serious losses or otherwise compromise a firm's financial integrity. Serious lapses or deficiencies in internal controls, including inadequate segregation of duties, may warrant supervisory action, including formal enforcement action.

When properly structured, an internal control system promotes effective operations and reliable financial and regulatory reporting; safeguards assets; and promotes compliance with relevant laws, regulations, and bank holding company policies. Ideally, internal controls are tested by an independent internal auditor who reports directly to either the bank holding company's board of directors or a designated board committee, typically the audit committee. Personnel who perform these reviews should generally be independent of the function they are assigned to review. Given the importance of appropriate internal controls, the results of audits or reviews, whether conducted by an internal auditor or other personnel, should be adequately documented, as well as senior management's responses to review findings. In addition, communication channels should exist that allow negative or sensitive findings to be reported directly to the board of directors or the relevant board committee.

In evaluating the adequacy of a bank holding company's internal controls and audit procedures, examiners should consider the following:

1. The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization's activities.
2. The bank holding company's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.
3. Reporting lines ensure that control areas are sufficiently independent from the business lines, and the reporting lines adequately separate duties throughout the organization, such as those duties relating to trading, custodial, and back-office activities.
4. Official organizational structures reflect actual operating practices.
5. Financial, operational, and regulatory reports are reliable, accurate, and timely. When applicable, policy exceptions are noted and promptly investigated.
6. Adequate procedures exist for ensuring compliance with applicable laws and regulations.
7. Internal audit or other control review practices ensure independence and objectivity of an audit or review.
8. Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits and review tests are adequately documented; identified material weaknesses are given appropriate and timely high-level attention; and management's actions to address material weaknesses are objectively verified and reviewed.
9. The board of directors or its audit committee engages in robust inquiry into the effectiveness of internal audits and other control review activities.

## 1062.0.1 RFI RATING SYSTEM INTRODUCTION

Since 2004, the Federal Reserve has used the “RFI/C(D)” rating system (referred to as the “RFI rating system”) to communicate its supervisory assessment of bank holding companies (BHCs) regardless of their asset size, complexity, or systemic importance.<sup>1</sup> In 2018, the Board adopted the RFI rating system for non-insurance and non-commercial savings and loan holding companies (SLHCs) with less than \$100 billion in total consolidated assets.<sup>2</sup> At the same time, the Board also adopted a rating system for BHCs and non-insurance and non-commercial savings and loan holding companies with total consolidated assets of \$100 billion or more (referred to as the “LFI rating system”).<sup>3</sup> As a result, the Federal Reserve has two frameworks for rating holding companies.

## 1062.0.2 RFI RATING SYSTEM APPLICABILITY

The RFI rating system generally applies to BHCs and non-insurance and non-commercial savings and loan holding companies with less than \$100 billion in total consolidated assets. Examination staff assign and communicate ratings to BHCs and non-insurance and non-commercial savings and loan holding companies with total consolidated assets between \$10 billion and \$100 billion assets on at least an annual basis, and more frequently as warranted. However, U.S. intermediate holding companies of foreign banking organizations (FBOs) established under the Board’s Regulation YY that have \$50 billion or more in total consolidated assets would be subject to the LFI rating system.

1. 69 Fed. Reg. 70,444 (December 6, 2004).

2. SLHCs that are excluded from the definition of “covered holding company” in section 217.2 of the Board’s Regulation Q receive indicative supervisory ratings. Section 271.2 excludes the following SLHCs: (1) SLHCs that derive 50 percent or more of their total consolidated assets or total revenues from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956, as amended (12 USC 1843(k)) (commercial SLHCs), and (2) SLHCs that are insurance companies or hold 25 percent or more of their total consolidated assets in subsidiaries that are insurance companies (insurance SLHCs).

3. See 83 Fed. Reg. 58,724 (November 21, 2018) and 84 Fed. Reg. 4309 (February 15, 2019).

## 1062.0.3 RFI RATING AND SAVINGS AND LOAN HOLDING COMPANIES

The Dodd-Frank Wall Street Reform and Consumer Protection Act transferred to the Federal Reserve the supervisory functions of the Office of Thrift Supervision related to SLHCs and their nondepository subsidiaries beginning on July 21, 2011. At that time, the Federal Reserve decided to issue “indicative RFI ratings” to SLHCs until such time that a rating system was formally adopted for these companies.

In November 2018, the Federal Reserve adopted a final rule to apply the RFI rating system on a fully implemented basis to SLHCs with less than \$100 billion in total consolidated assets, excluding SLHCs engaged in significant insurance or commercial activities.<sup>4</sup> Therefore, starting on February 1, 2019, the Federal Reserve will assign an RFI rating to non-insurance and non-commercial SLHCs with less than \$100 billion in total consolidated assets. Non-insurance and non-commercial SLHCs face similar risks and engage largely in the same activities as BHCs. As such, it is appropriate for the RFI rating system to apply to non-insurance and non-commercial SLHCs to ensure that they are subject to standards and supervisory programs that are consistent with those that apply to BHCs. Inspection frequency and scope guidance for non-insurance and non-commercial SLHCs with \$10 billion or less in total consolidated assets are described in [SR letter 13-21](#), “Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of \$10 Billion or Less.” Further, in November 2018, the Federal Reserve adopted the LFI rating system for non-insurance or non-commercial SLHCs with total consolidated assets of \$100 billion or more.

The Federal Reserve will continue to assign an indicative RFI rating to SLHCs engaged in significant insurance or commercial activities, regardless of asset size. The Federal Reserve is in the process of reviewing whether a modified version of the RFI rating system, LFI rating system, or some other supervisory rating system is appropriate for these firms on a permanent basis.

4. 83 Fed. Reg. 56,081 (November 7, 2018).

1062.0.4 RFI RATING SYSTEM

The RFI rating system provides an assessment of certain risk management and financial condition factors that are common to holding companies,<sup>5</sup> as well as an assessment of the potential impact of the parent holding company and its nondepository subsidiaries (collectively, nondepository entities) on the holding company’s subsidiary depository institutions. Under this system, the Federal Reserve endeavors to ensure that applicable BHCs, including financial holding companies, and non-insurance and non-commercial SLHCs are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on the holding companies that exhibit financial and operational weaknesses or adverse trends. The RFI rating system serves as a useful vehicle for identifying problem or deteriorating holding companies, as well as for categorizing holding companies with deficiencies in particular areas. Further, the RFI rating system assists the Federal Reserve in following safety-and-soundness trends and in assessing the aggregate strength and soundness of the financial industry.

Each holding company subject to the RFI rating system is assigned a composite rating (C) based on an overall evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s).<sup>6</sup> The main components of the rating system represent: Risk Management (R); Financial Condition (F); and Impact (I) of the nondepository entities on the subsidiary depository institutions. While the Federal Reserve expects holding companies to act as a source of strength to their subsidiary depository institutions, the Impact rating focuses on downside risk—that is, on the likelihood of significant negative impact by the nondepository entities on the subsidiary depository institu-

tion(s).<sup>7</sup> A fourth rating, Depository Institution(s) (D), will generally mirror the primary regulator’s assessment of the subsidiary depository institution(s). Thus, the primary component and composite ratings are displayed:

**RFI / C (D)**

In order to provide a consistent framework for assessing risk management, the R component is supported by four subcomponents that reflect the effectiveness of the organization’s risk management and controls. The subcomponents are Board and Senior Management Oversight; Policies, Procedures, and Limits; Risk Monitoring and Management Information Systems (MIS); and Internal Controls. The F component is also supported by four subcomponents reflecting an assessment of the quality of the consolidated organization’s Capital, Asset Quality, Earnings, and Liquidity.

Composite, component, and subcomponent ratings are assigned based on a 1 to 5 numeric scale. A 1 numeric rating indicates the highest rating, strongest performance and practices, and least degree of supervisory concern, whereas a 5 numeric rating indicates the lowest rating, weakest performance, and the highest degree of supervisory concern.

The sections that follow contain detailed descriptions of the composite, component, and subcomponent ratings; implementation guidance by holding company type; and definitions of the ratings.

1062.0.5 DESCRIPTION OF THE RFI RATING SYSTEM ELEMENTS

1062.0.5.1 The Composite (C) Rating

C is the overall composite assessment of the holding company as reflected by consolidated risk management, consolidated financial strength, and the potential impact of the nondepository entities on the subsidiary depository institutions. The composite rating encompasses both a forward-looking and static assessment of the consolidated organization, as well as an assessment of the relationship between the depository and nondepository entities. The C rating is not derived as a simple numeric average of the R, F, and I components; rather, it reflects examiner judgment with respect to the relative importance

5. The information in this manual section largely conveys the information in the original 2004 RFI rating system document conveyed in 69 Fed. Reg. 70,444 (December 6, 2004). However, the information was revised to clarify the applicability of the rating system and to provide current references to regulations and guidance. The elements of the RFI rating system and the ratings’ definitions are unchanged. See [SR letter 19-4](#), “Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than \$100 billion.”

6. A simplified version of the rating system that includes only the R and C components will be applied to noncomplex holding companies with assets at or below \$3 billion. See SR-13-21 for more information.

7. In 2004, this risk-management rating replaced the risk-management rating required for bank holding companies by [SR letter 95-51](#), “Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies.”

of each component to the safe-and-sound operation of the holding company.

### 1062.0.5.2 The Risk Management (R) Component

R represents an evaluation of the ability of the holding company's board of directors and senior management, as appropriate for their respective positions, to identify, measure, monitor, and control risk. The R rating underscores the importance of the control environment, taking into consideration the complexity of the organization and the risk inherent in its activities.

The R rating is supported by four subcomponents that are each assigned a separate rating. The four subcomponents are as follows: (1) Board and Senior Management Oversight; (2) Policies, Procedures and Limits; (3) Risk Monitoring and Management Information Systems; and (4) Internal Controls. The subcomponents are evaluated in the context of the risks undertaken by and inherent in an organization and the overall level of complexity of the holding company's operations. They provide the Federal Reserve System with a consistent framework for evaluating risk management and the control environment. Moreover, the subcomponents provide a clear structure and basis for discussion of the R rating with holding company management, reflect the principles in supervisory guidance that are familiar to examiners, and parallel the existing risk assessment process.<sup>8</sup>

#### 1062.0.5.2.1 Risk Management Subcomponents

##### Board and Senior Management Oversight

This subcomponent evaluates the adequacy and effectiveness of board and senior management's understanding and management of risk inherent in the holding company's activities, as well as the general capabilities of management.<sup>9</sup> It also includes consideration of management's ability to identify, understand, and control the risks undertaken by the institution, to hire competent

staff, and to respond to changes in the institution's risk profile or innovations in the banking sector.

##### Policies, Procedures, and Limits

This subcomponent evaluates the adequacy of a holding company's policies, procedures, and limits given the risks inherent in the activities of the consolidated organization and its stated goals and objectives. This analysis will include consideration of the adequacy of the institution's accounting and risk disclosure policies and procedures.

##### Risk Monitoring and Management Information Systems

This subcomponent assesses the adequacy of a holding company's risk measurement and monitoring, and the adequacy of its management reports and information systems. This analysis will include a review of the assumptions, data, and procedures used to measure risk and the consistency of these tools with the level of complexity of the organization's activities.

##### Internal Controls

This subcomponent evaluates the adequacy of a holding company's internal controls and internal audit procedures, including the accuracy of financial reporting and disclosure and the strength and influence, within the organization, of the internal audit team. This analysis will also include a review of the independence of control areas from management and the consistency of the scope coverage of the internal audit team with the complexity of the organization.

### 1062.0.5.3 The Financial Condition (F) Component

F represents an evaluation of the consolidated organization's financial strength. The F rating focuses on the ability of the holding company's resources to support the level of risk associated with its activities. The F rating is supported by four subcomponents: capital (C), asset quality (A), earnings (E), and liquidity (L). The CAEL subcomponents can be evaluated along

8. See SR-95-51 and [SR letter 16-11](#), "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$50 Billion." SR-95-51 and SR-16-11 contain a detailed description of the four risk-management subcomponents.

9. The board of directors is considered separate from management.

individual business lines, product lines, or on a legal entity basis, depending on what is most appropriate given the structure of the organization. The assessment of the CAEL components should utilize benchmarks and metrics appropriate to the business activity being evaluated.

Examination staff should continue to review relevant market indicators, such as external debt ratings, credit spreads, debt and equity prices, and qualitative rating agency assessments as a source of information complementary to examination findings.

1062.0.5.3.1 Financial Condition Subcomponents (CAEL)

Capital Adequacy

C reflects the adequacy of an organization’s consolidated capital position, from a regulatory capital perspective and an economic capital perspective, as appropriate to the holding company.<sup>10</sup> The evaluation of capital adequacy should consider the risk inherent in an organization’s activities and the ability of capital to absorb unanticipated losses, to provide a base for growth, and to support the level and composition of the parent company and subsidiaries’ debt.

Asset Quality

A reflects the quality of an organization’s consolidated assets. The evaluation should include, as appropriate, both on-balance sheet and off-balance sheet exposures, and the level of criticized and nonperforming assets. Forward-looking indicators of asset quality, such as the adequacy of underwriting standards, the level of concentration risk, the adequacy of credit administration policies and procedures, and the adequacy of management information systems for credit risk may also inform the Federal Reserve’s view of asset quality.

10. The regulatory minimum capital ratios for covered holding companies subject to the Board’s Regulation Q (12 CFR part 217) are (1) a common equity tier 1 capital ratio of 4.5 percent; (2) a tier 1 capital ratio of 6 percent; (3) a total capital ratio of 8 percent; (4) a leverage ratio of 4 percent, and (5) for advanced approaches Board-regulated institutions, a supplementary leverage ratio of 3 percent.

Earnings

E reflects the quality of consolidated earnings. The evaluation considers the level, trend, and sources of earnings, as well as the ability of earnings to augment capital as necessary, to provide ongoing support for a holding company’s activities.

Liquidity

L 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.

1062.0.5.4 The Impact (I) Component

Like the other components and subcomponents, the I component is rated on a five-point numerical scale. However, the descriptive definitions of the numerical ratings for I are different than those of the other components and subcomponents. The I ratings are defined as follows:

- 1—low likelihood of significant negative impact;
- 2—limited likelihood of significant negative impact;
- 3—moderate likelihood of significant negative impact;
- 4—considerable likelihood of significant negative impact; and
- 5—high likelihood of significant negative impact.

The I component is an assessment of the potential impact of the nondepository entities on the subsidiary depository institution(s). The I assessment will evaluate both the risk-management practices and financial condition of the nondepository entities—an analysis that will borrow heavily from the analysis conducted for the R and F components. Nondepository entities will be evaluated using benchmarks and analysis appropriate for those businesses. In addition, for functionally regulated nondepository subsidiaries, examination staff will continue to rely, to the extent possible, on the work of those functional regulators to assess the risk management practices and financial condition of those entities. In rating the I component, examination

staff is required to evaluate the degree to which current or potential issues within the nondepository entities present a threat to the safety and soundness of the subsidiary depository institution(s).

The I component focuses on the aggregate impact of the nondepository entities on the subsidiary depository institution(s). In this regard, the I rating does not include individual subcomponent ratings for the parent company and nondepository subsidiaries. An I rating is always assigned for each holding company; however, nonmaterial nondepository subsidiaries may be excluded from the I analysis at examiner discretion.<sup>11</sup>

Any risk-management and financial issues at the nondepository entities that potentially impact the safety and soundness of the subsidiary depository institution(s) should be identified in the written comments under the I rating. This approach is consistent with the Federal Reserve's objective not to extend bank-like supervision to nondepository entities.

The analysis of the parent company for the purpose of assigning an I rating should emphasize weaknesses that could directly impact the risk-management or financial condition of the subsidiary depository institution(s). Similarly, the analysis of the nondepository subsidiaries for the purpose of assigning an I rating should emphasize weaknesses that could negatively impact the parent company's relationship with its subsidiary depository institution(s) and weaknesses that could have a direct impact on the risk-management practices or financial condition of the subsidiary depository institution(s). The analysis under the I component should consider existing as well as potential issues and risks that may impact the subsidiary depository institution(s) now or in the future. Particular attention should be paid to the following risk-management and financial factors in assigning the I rating:

- *Operational Considerations:* The spillover impact on the subsidiary depository institution(s) from actual losses, a poor control environment, or an operational loss history in the nondepository entities;
- *Legal and Reputational Considerations:* The spillover effect on the subsidiary depository institution(s) of complaints and litigation that name one or more of the nondepository entities as defendants, or violations of laws or regulations, especially pertaining to intercompany transactions where the subsidiary depository institution(s) is involved; and
- *Concentration Considerations:* The potential risks posed to the subsidiary depository institution(s) by concentrations within the nondepository entities in business lines, geographic areas, industries, customers, or other factors.

#### 1062.0.5.4.2 Financial Factors

- *Capital Distribution:* The distribution and transferability of capital across the legal entities;
- *Intra-Group Exposures:* The extent to which intra-group exposures, including servicing agreements, have the potential to undermine the condition of subsidiary depository institution(s); and
- *Parent Company Cash Flow and Leverage:* The extent to which the parent company is dependent on dividend payments, from both the nondepository subsidiaries and the subsidiary depository institution(s), to service debt and cover fixed charges. Also, the effect that these upstreamed cash flows have had, or can be expected to have, on the financial condition of the holding company's nondepository subsidiaries and subsidiary depository institution(s).

#### 1062.0.5.5 The Depository Institution(s) (D) Component

The (D) component will generally reflect the composite CAMELS rating assigned by the subsidiary depository institution's primary supervisor. In a multi-depository institution holding company, the (D) rating will reflect a weighted average of the CAMELS composite ratings of the individual subsidiary depository institutions, weighted by both asset size and the relative importance of each depository institution within the holding company structure. In this regard,

#### 1062.0.5.4.1 Risk-Management Factors

- *Strategic Considerations:* The potential risks posed to the subsidiary depository institution(s) by the nondepository entities' strategic plans for growth in existing activities and expansion into new products and services;

11. In general, nondepository subsidiaries should be included in the I analysis whenever their assets exceed 5 percent of the holding company's consolidated capital or \$10 million, whichever is lower.

the CAMELS composite rating for a subsidiary depository institution that dominates the corporate culture may figure more prominently in the assignment of the (D) rating than would be dictated by asset size, particularly when problems exist within that depository institution.

The (D) component conveys important supervisory information, reflecting the primary supervisor’s assessment of the legal entity. The (D) component stands outside of the composite rating although significant risk-management and financial condition considerations at the depository institution level are incorporated in the consolidated R and F ratings, which are then factored into the C rating.

In the process of analyzing the financial condition and risk-management programs of the consolidated organization, a major difference of opinion regarding the safety and soundness of the subsidiary depository institution(s) emerges between the Federal Reserve and the depository institution’s primary regulator, then the (D) rating should reflect the Federal Reserve’s evaluation.

To highlight the presence of one or more problem depository institution(s) in a multi-depository institution holding company whose depository institution component, based on weighted averages, might not otherwise reveal their presence (i.e., depository institution ratings of 1, 2, or 3), a problem modifier, “P” would be attached to the depository institution rating (e.g., 1P, 2P, or 3P). Thus, 2P would indicate that, while on balance the depository subsidiaries are rated satisfactory, there exists a problem depository institution (composite 4 or 5) among the subsidiary depository institutions. The problem identifier is unnecessary when the depository institution component is rated 4 or 5.

1062.0.6 IMPLEMENTATION OF THE RFI RATING SYSTEM BY HOLDING COMPANY TYPE

Since 2004, the Federal Reserve has used the RFI rating system to communicate its supervisory assessment of BHCs regardless of their asset size, complexity, or systemic importance. In 2018, the Board adopted the RFI rating system for non-insurance and non-commercial SLHCs with less than \$100 billion in total consolidated assets. The scope and frequency of inspections of holding companies under the RFI rating system will vary based upon whether a

holding company has been determined to be “complex” or “noncomplex.”<sup>12</sup> In addition, the resources dedicated to the inspection of each holding company will continue to be determined by the risk posed by the subsidiary depository institution(s) to the federal safety net and the risk posed by the holding company to the subsidiary depository institution(s).<sup>13</sup>

1062.0.6.1 Noncomplex Holding Companies with Assets of \$3 Billion or Less (Shell Holding Companies)  
Rating: R and C

Examination staff will assign only an R and C rating for all noncomplex holding companies with assets under \$3 billion.<sup>14</sup> The R rating is the M rating from the subsidiary depository institution’s CAMELS rating. The C rating is the subsidiary depository institution’s composite CAMELS rating.

1062.0.6.2 Noncomplex Holding Companies with Assets Greater than \$3 Billion

1062.0.6.2.1 One-Depository Institution Holding Company Rating: RFI/C(D)

For all noncomplex, one-depository institution holding companies with assets of greater than \$3 billion, examination staff will assign all component and subcomponent ratings; however, examination staff should rely heavily on information and analysis contained in the primary regulator’s report of examination for the subsidiary depository institution to assign the R and F ratings. If examination staff have reviewed the

12. The determination of whether a holding company is “complex” versus “noncomplex” is made at least annually on a case-by-case basis taking into account and weighing a number of considerations, such as: the size and structure of the holding company; the extent of intercompany transactions between depository institution subsidiaries and the holding company or nondepository subsidiaries of the holding company; the nature and scale of any nondepository activities, including whether the activities are subject to review by another regulator and the extent to which the holding company is conducting Gramm-Leach-Bliley authorized activities (e.g., insurance, securities, merchant banking); whether risk-management processes for the holding company are consolidated; and whether the holding company has material debt outstanding to the public. Size is a less important determinant of complexity than many of the factors noted above.

13. The federal safety net includes the federal deposit insurance fund, the payments system, and the Federal Reserve’s discount window.

14. Refer to SR-13-21.

primary regulator's examination report and are comfortable with the analysis and conclusions contained in that report, then the holding company ratings should be supported with concise language that indicates that the conclusions are based on the analysis of the primary regulator. No additional analysis will be required.

Please note, however, in cases where the analysis and conclusions of the primary regulator are insufficient to assign the ratings, the primary regulator should be contacted to ascertain whether additional analysis and support may be available. Further, if discussions with the primary regulator do not provide sufficient information to assign the ratings, discussions with holding company management may be warranted to obtain adequate information to assign the ratings. In most cases, additional information or support obtained through these steps will be sufficient to permit the assignment of the R and F ratings. To the extent that additional analysis is deemed necessary, the level of analysis and resources spent on this assessment should be in line with the level of risk the subsidiary depository institution poses to the federal safety net. In addition, any activities that involve information gathering with respect to the subsidiary depository institution should be coordinated with and, if possible, conducted by, the primary regulator of that institution.

Examination staff are required to make an independent assessment in order to assign the I rating, which provides an evaluation of the impact of the holding company on the subsidiary depository institution. Analysis for the I rating in non-complex one-depository institution holding companies should place particular emphasis on issues related to parent company cash flow and compliance with sections 23A and 23B of the Federal Reserve Act.

#### *1062.0.6.2.2 Multi-Depository Institution Holding Company Rating: RFI/C(D)*

For all noncomplex holding companies with assets of greater than \$3 billion and more than one subsidiary depository institution, examination staff will assign all component and subcomponent ratings of the RFI rating system. Examiners should rely, to the extent possible, on the work conducted by the primary regulators of the subsidiary depository institutions to assign the R and F ratings. However, any risk management or other important functions conducted by the nondepository entities of the holding company, or conducted across legal entity lines, should be subject to review by Federal Reserve examina-

tion staff. These reviews should be conducted in coordination with the primary regulator(s). The assessment for the I rating requires an independent assessment by Federal Reserve examination staff.

#### **1062.0.6.3 Complex Holding Companies Rating: RFI/C(D)**

For complex holding companies, examination staff will assign all component and subcomponent ratings of the RFI rating system. The ratings analysis should be based on the primary and functional regulators' assessment of the subsidiary entities, as well as on the examiners' assessment of the consolidated organization as determined through off-site review and the holding company inspection process, as appropriate. The resources needed for the inspection and the level of support needed for developing a full rating will depend on the complexity of the organization, including structure and activities, and should be commensurate with the level of risk posed by the subsidiary depository institution(s) to the federal safety net and the level of risk posed by the holding company to the subsidiary depository institution(s).

#### **1062.0.6.4 Nontraditional Holding Companies Rating: RFI/C(D)**

Examination staff are required to assign the full-rating system for nontraditional holding companies. Nontraditional holding companies include holding companies in which most or all nondepository entities are regulated by a functional regulator and in which the subsidiary depository institution(s) are small in relation to the nondepository entities.<sup>15</sup> The rating system is not intended to introduce significant additional work in the rating process for these organizations. As discussed above, the level of analysis conducted and resources needed to inspect the holding company and to assign the consolidated R and F ratings should be commensurate with the level

15. SLHCs that derive 50 percent or more of their total consolidated assets or total revenues from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956, as amended (12 USC 1843(k)) (commercial SLHCs), and SLHCs that are insurance companies or hold 25 percent or more of their total consolidated assets in subsidiaries that are insurance companies (insurance SLHCs) will receive an "indicative" RFI rating regardless of size.

of risk posed by the subsidiary depository institution(s) to the federal safety net and the level of risk posed by the holding company to the subsidiary depository institution(s). The report of examination by, and other information obtained from, the functional and primary bank regulators should provide the basis for the consolidated R and F ratings. On-site work, to the extent it involves areas that are the primary responsibility of the functional or primary depository institution(s) regulator, should be coordinated with and, if possible, conducted by, those regulators. Examination staff should concentrate their independent analysis for the R and F ratings around activities and risk management conducted by the parent company and non-functionally regulated nondepository subsidiaries, as well as around activities and risk management functions that are related to the subsidiary depository institution(s), for example, audit functions for the depository institution(s) and compliance with sections 23A and 23B.

Examination staff are required to make an independent assessment of the impact of the nondepository entities on the subsidiary depository institution(s) in order to assign the I rating.

## 1062.0.7 RATING DEFINITIONS FOR THE RFI/C(D) RATING SYSTEM

All component and subcomponent ratings are rated on a five-point numeric scale. With the exception of the I component, ratings will be assigned in ascending order of supervisory concern as follows:

1—Strong; 2—Satisfactory; 3—Fair; 4— Marginal; and 5—Unsatisfactory.

A description of the I component ratings can be found below in subsection 1062.0.7.4, “Impact Component.”

The component ratings are not derived as a simple numeric average of the subcomponent ratings; rather, weight afforded to each subcomponent in the overall component rating will depend on the severity of the condition of that subcomponent and the relative importance of that subcomponent to the consolidated organization. Similarly, some components may be given more weight than others in determining the composite rating, depending on the situation of the holding company. Assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the holding company, although generally

the composite rating bears a close relationship to the component ratings assigned.

### 1062.0.7.1 Composite Rating

*Rating 1 (Strong).* Holding companies in this group are sound in almost every respect; any negative findings are basically of a minor nature and can be handled in a routine manner. Risk management practices and financial condition provide resistance to external economic and financial disturbances. Cash flow is more than adequate to service debt and other fixed obligations, and the nondepository entities pose little risk to the subsidiary depository institution(s).

*Rating 2 (Satisfactory).* Holding companies in this group are fundamentally sound but may have modest weaknesses in risk-management practices or financial condition. The weaknesses could develop into conditions of greater concern but are believed correctable in the normal course of business. As such, the supervisory response is limited. Cash flow is adequate to service obligations, and the nondepository entities are unlikely to have a significant negative impact on the subsidiary depository institution(s).

*Rating 3 (Fair).* Holding companies in this group exhibit a combination of weaknesses in risk-management practices and financial condition that range from fair to moderately severe. These companies are less resistant to the onset of adverse business conditions and would likely deteriorate if concerted action is not effective in correcting the areas of weakness. Consequently, these companies are vulnerable and require more than normal supervisory attention and financial surveillance. However, the risk management and financial capacity of the company, including the potential negative impact of the nondepository entities on the subsidiary depository institution(s), pose only a remote threat to its continued viability.

*Rating 4 (Marginal).* Holding companies in this group have an immoderate volume of risk management and financial weaknesses, which may pose a heightened risk of significant negative impact on the subsidiary depository institution(s). The holding company’s cash flow needs may be being met only by upstreaming imprudent dividends and/or fees from its subsidiaries. Unless prompt action is taken to correct these conditions, the organization’s future viability could be impaired. These companies require close supervisory attention and substantially increased financial surveillance.

*Rating 5 (Unsatisfactory).* The critical volume and character of the risk management and

financial weaknesses of holding companies in this category, and concerns about the nondepository entities negatively impacting the subsidiary depository institution(s), could lead to insolvency without urgent aid from shareholders or other sources. The imminent inability to prevent liquidity and/or capital depletion places the holding company's continued viability in serious doubt. These companies require immediate corrective action and constant supervisory attention.

### 1062.0.7.2 Risk-Management Component

*Rating 1 (Strong).* A rating of 1 indicates that management effectively identifies and controls all major types of risk posed by the holding company's activities. Management is fully prepared to address risks emanating from new products and changing market conditions. The board and management are forward-looking and active participants in managing risk. Management ensures that appropriate policies and limits exist and are understood, reviewed, and approved by the board. Policies and limits are supported by risk-monitoring procedures, reports, and management information systems that provide management and the board with the information and analysis that is necessary to make timely and appropriate decisions in response to changing conditions. Risk-management practices and the organization's infrastructure are flexible and highly responsive to changing industry practices and current regulatory guidance. Staff has sufficient experience, expertise and depth to manage the risks assumed by the institution.

Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the institution. There are few noted exceptions to the institution's established policies and procedures, and none are material. Management effectively and accurately monitors the condition of the institution consistent with the standards of safety and soundness, and in accordance with internal and supervisory policies and practices. Risk-management processes are fully effective in identifying, monitoring, and controlling the risks to the institution.

*Rating 2 (Satisfactory).* A rating of 2 indicates that the institution's management of risk is largely effective, but lacking in some modest degree. Management demonstrates a responsiveness and ability to cope successfully with existing and foreseeable risks that may arise in carrying out the institution's business plan. While the

institution may have some minor risk-management weaknesses, these problems have been recognized and are in the process of being resolved. Overall, board and senior management oversight, policies and limits, risk monitoring procedures, reports, and management information systems are considered satisfactory and effective in maintaining a safe and sound institution. Risks are controlled in a manner that does not require more than normal supervisory attention.

The holding company's risk-management practices and infrastructure are satisfactory and generally are adjusted appropriately in response to changing industry practices and current regulatory guidance. Staff experience, expertise and depth are generally appropriate to manage the risks assumed by the institution.

Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the safety and soundness of the institution.

*Rating 3 (Fair).* A rating of 3 signifies that risk-management practices are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound risk management (active board and senior management oversight; adequate policies, procedures, and limits; adequate risk-management monitoring and management information systems; comprehensive internal controls) is considered less than acceptable,<sup>16</sup> and has precluded the institution from fully addressing one or more significant risks to its operations. Certain risk-management practices are in need of improvement to ensure that management and the board are able to identify, monitor, and control all significant risks to the institution. Also, the risk-management structure may need to be improved in areas of significant business activity, or staff expertise may not be commensurate with the scope and complexity of business activities. In addition, management's response to changing industry practices and regulatory guidance may need to improve.

The internal control system may be lacking in some important aspects, particularly as indicated by continued control exceptions or by a failure to adhere to written policies and procedures. The risk-management weaknesses could

16. See SR - 95-51 and SR-16-11.

have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

*Rating 4 (Marginal).* A rating of 4 represents deficient risk-management practices that fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management and the board. One or more of the four elements of sound risk management is deficient and requires immediate and concerted corrective action by the board and management.

The institution may have serious identified weaknesses, such as an inadequate separation of duties, that require substantial improvement in internal control or accounting procedures, or improved adherence to supervisory standards or requirements. The risk-management deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

*Rating 5 (Unsatisfactory).* A rating of 5 indicates a critical absence of effective risk-management practices with respect to the identification, monitoring, or control over significant risk exposures. One or more of the four elements of sound risk management is considered wholly deficient, and management and the board have not demonstrated the capability to address these deficiencies.

Internal controls are critically weak and, as such, could seriously jeopardize the continued viability of the institution. If not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and the potential for losses if corrective measures are not taken immediately. Deficiencies in the institution's risk-management procedures and internal controls require immediate and close supervisory attention.

1062.0.7.2.1 Risk Management  
Subcomponents

Board and Senior Management Oversight

*Rating 1 (Strong).* An assessment of "Strong" signifies that the board and senior management are forward-looking, fully understand the types of risk inherent in the holding company's activities, and actively participate in managing those

risks. The board has approved overall business strategies and significant policies, and ensures that senior management is fully capable of managing the activities that the holding company conducts. Consistent with the standards of safety and soundness, oversight of risk-management practices is strong and the organization's overall business strategy is effective.

Senior management ensures that risk-management practices are rapidly adjusted in accordance with enhancements to industry practices and regulatory guidance, and exposure limits are adjusted as necessary to reflect the institution's changing risk profile. Policies, limits, and tracking reports are appropriate, understood, and regularly reviewed.

Management provides effective supervision of the day-to-day activities of all officers and employees, including the supervision of the senior officers and the heads of business lines. It hires staff that possess experience and expertise consistent with the scope and complexity of the organization's business activities. There is a sufficient depth of staff to ensure sound operations. Management ensures compliance with laws and regulations and that employees have the integrity, ethical values, and competence consistent with a prudent management philosophy and operating style.

Management responds appropriately to changes in the marketplace. It identifies all risks associated with new activities or products before they are launched, and ensures that the appropriate infrastructure and internal controls are established.

*Rating 2 (Satisfactory).* An assessment of "Satisfactory" indicates that board and senior management have an adequate understanding of the organization's risk profile and provide largely effective oversight of risk-management practices. In this regard, the board has approved all major business strategies and significant policies, and ensures that senior management is capable of managing the activities that the holding company conducts. Oversight of risk-management practices is satisfactory and the organization's overall business strategy is generally sound.

Senior management generally adjusts risk-management practices appropriately in accordance with enhancements to industry practices and regulatory guidance, and adjusts exposure limits as necessary to reflect the institution's changing risk profile, although these practices may be lacking in some modest degree. Policies, limits, and tracking reports are generally appropriate, understood, and regularly reviewed, and the new product approval process ad-

equately identifies the associated risks and necessary controls.

Senior management's day-to-day supervision of management and staff at all levels is generally effective. The level of staffing, and its experience, expertise, and depth, is sufficient to operate the business lines in a safe and sound manner. Minor weaknesses may exist in the staffing, infrastructure, and risk-management processes for individual business lines or products, but these weaknesses have been identified by management, are correctable in the normal course of business, and are in the process of being addressed. Weaknesses noted should not have a significant effect on the safety and soundness of the institution.

*Rating 3 (Fair).* An assessment of "Fair" signifies that board and senior management oversight is lacking in some important way and, therefore, is a cause for more than normal supervisory attention. The weaknesses may involve a broad range of activities or be material to a major business line or activity. Weaknesses in one or more aspect of board and senior management oversight have precluded the institution from fully addressing one or more significant risks to the institution. The deficiencies may include a lack of knowledge with respect to the organization's risk profile, insufficient oversight of risk-management practices, ineffective policies or limits, inadequate or under-utilized management reporting, an inability to respond to industry enhancements and changes in regulatory guidance, or failure to execute appropriate business strategies. Staffing may not be adequate or staff may not possess the experience and expertise needed for the scope and complexity of the organization's business activities. The day-to-day supervision of officer and staff activities, including the management of senior officers or heads of business lines, may be lacking. Certain risk-management practices are in need of improvement to ensure that management and the board is able to identify, monitor, and control all significant risks to the institution. Weaknesses noted could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

*Rating 4 (Marginal).* An assessment of "Marginal" represents deficient oversight practices that reflect a lack of adequate guidance and supervision by management and the board. A number of significant risks to the institution have not been adequately addressed, and the board and senior management function warrants a high degree of supervisory attention. Multiple board and senior management weaknesses are in need of immediate improvement. They may

include a significant lack of knowledge with respect to the organization's risk profile, largely insufficient oversight of risk-management practices, ineffective policies or limits, inadequate or considerably under-utilized management reporting, an inability to respond to industry enhancements and changes in regulatory guidance, or failure to execute appropriate business strategies. Staffing may not be adequate or possess the experience and expertise needed for the scope and complexity of the organization's business activities, and the day-to-day supervision of officer and staff activities, including the management of senior officers or heads of business lines, may be considerably lacking. These conditions warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

*Rating 5 (Unsatisfactory).* An assessment of "Unsatisfactory" indicates a critical absence of effective board and senior management oversight practices. Problems may include a severe lack of knowledge with respect to the organization's risk profile, insufficient oversight of risk-management practices, wholly ineffective policies or limits, critically inadequate or under-utilized management reporting, a complete inability to respond to industry enhancements and changes in regulatory guidance, or failure to execute appropriate business strategies. Staffing may be inadequate, inexpert, and/or inadequately supervised. The deficiencies require immediate and close supervisory attention, as management and the board have not demonstrated the capability to address them. Weaknesses could seriously jeopardize the continued viability of the institution.

#### Policies, Procedures, and Limits

*Rating 1 (Strong).* An assessment of "Strong" indicates that the policies, procedures, and limits provide for effective identification, measurement, monitoring, and control of the risks posed by all significant activities, including lending, investing, trading, trust, and fiduciary activities. Policies, procedures, and limits are consistent with the institution's goals and objectives and its overall financial strength. The policies clearly delineate accountability and lines of authority across the institution's activities. The policies also provide for the review of new activities to ensure that the infrastructure necessary to iden-

tify, monitor, and control the associated risks is in place before the activities are initiated.

**Rating 2 (Satisfactory).** An assessment of “Satisfactory” indicates that the policies, procedures, and limits cover all major business areas, are thorough and substantially up-to-date, and provide a clear delineation of accountability and lines of authority across the institution’s activities. Policies, procedures, and limits are generally consistent with the institution’s goals and objectives and its overall financial strength. Also, the policies provide for adequate due diligence before engaging in new activities or products. Any deficiencies or gaps that have been identified are minor in nature and in the process of being addressed. Weaknesses should not have a significant effect on the safety and soundness of the institution.

**Rating 3 (Fair).** An assessment of “Fair” signifies that deficiencies exist in policies, procedures, and limits that require more than normal supervisory attention. The deficiencies may involve a broad range of activities or be material to a major business line or activity. The deficiencies may include policies, procedures, or limits (or the lack thereof) that do not adequately identify, measure, monitor, or control the risks posed by significant activities; are not consistent with the experience of staff, the organization’s strategic goals and objectives, or the financial strength of the institution; or do not clearly delineate accountability or lines of authority. Also, the policies may not provide for adequate due diligence before engaging in new activities or products. Weaknesses noted could have adverse effects on the safety and soundness of the institution unless corrective action is taken by management.

**Rating 4 (Marginal).** An assessment of “Marginal” indicates deficient policies, procedures, and limits that do not address a number of significant risks to the institution. Multiple practices are in need of immediate improvement, which may include policies, procedures, or limits (or the lack thereof) that ineffectively identify, measure, monitor, or control the risks posed by significant activities; are not commensurate with the experience of staff, the institution’s strategic goals and objectives, or the financial strength of the institution; or do not delineate accountability or lines of authority. Moreover, policies may be considerably lacking with regards to providing for effective due diligence before engaging in new activities or products. These conditions warrant a high degree of super-

visory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

**Rating 5 (Unsatisfactory).** An assessment of “Unsatisfactory” indicates a critical absence of effective policies, procedures, and limits. Policies, procedures, or limits (or the lack thereof) are largely or entirely ineffective with regard to identifying, measuring, monitoring, or controlling the risks posed by significant activities; are completely inconsistent with the experience of staff, the organization’s strategic goals and objectives, or the financial strength of the institution; or do not delineate accountability or lines of authority. Also, policies may be completely lacking with regard to providing for effective due diligence before engaging in new activities or products. Critical weaknesses could seriously jeopardize the continued viability of the institution and require immediate and close supervisory attention.

## Risk Monitoring and MIS

**Rating 1 (Strong).** An assessment of “Strong” indicates that risk-monitoring practices and MIS reports address all material risks. The key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate, thoroughly documented, and frequently tested for reliability. Reports and other forms of communication are consistent with activities, are structured to monitor exposures and compliance with established limits, goals, or objectives, and compare actual versus expected performance when appropriate. Management and board reports are accurate and timely and contain sufficient information to identify adverse trends and to thoroughly evaluate the level of risk faced by the institution.

**Rating 2 (Satisfactory).** An assessment of “Satisfactory” indicates that risk-monitoring practices and MIS reports cover major risks and business areas, although they may be lacking in some modest degree. In general, the reports contain valid assumptions that are periodically tested for accuracy and reliability and are adequately documented and distributed to the appropriate decisionmakers. Reports and other forms of communication generally are consistent with activities; are structured to monitor exposures and compliance with established limits, goals, or objectives; and compare actual versus expected performance when appropriate. Management and board reports are generally accurate and timely, and broadly identify adverse trends and the level of risk faced by the

institution. Any weaknesses or deficiencies that have been identified are in the process of being addressed.

*Rating 3 (Fair).* An assessment of “Fair” signifies that weaknesses exist in the institution’s risk-monitoring practices or MIS reports that require more than normal supervisory attention. The weaknesses may involve a broad range of activities or be material to a major business line or activity. They may contribute to ineffective risk identification or monitoring through inappropriate assumptions, incorrect data, poor documentation, or the lack of timely testing. In addition, MIS reports may not be distributed to the appropriate decisionmakers, adequately monitor significant risks, or properly identify adverse trends and the level of risk faced by the institution. Weaknesses noted could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

*Rating 4 (Marginal).* An assessment of “Marginal” represents deficient risk-monitoring practices or MIS reports that, unless properly addressed, could seriously affect the safety and soundness of the institution. A number of significant risks to the institution are not adequately monitored or reported. Ineffective risk identification may result from notably inappropriate assumptions, incorrect data, poor documentation, or the lack of timely testing. In addition, MIS reports may not be distributed to the appropriate decisionmakers, may inadequately monitor significant risks, or fail to identify adverse trends and the level of risk faced by the institution. The risk monitoring and MIS deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

*Rating 5 (Unsatisfactory).* An assessment of “Unsatisfactory” indicates a critical absence of risk monitoring and MIS. They are wholly deficient due to inappropriate assumptions, incorrect data, poor documentation, or the lack of timely testing. Moreover, MIS reports may not be distributed to the appropriate decisionmakers, fail to monitor significant risks, or fail to identify adverse trends and the level of risk faced by the institution. These critical weaknesses require immediate and close supervisory attention, as they could seriously jeopardize the continued viability of the institution.

## Internal Controls

*Rating 1 (Strong).* An assessment of “Strong” indicates that the system of internal controls is

robust for the type and level of risks posed by the nature and scope of the organization’s activities. The organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits, and wherever applicable, exceptions are noted and promptly investigated. Reporting lines provide clear independence of the control areas from the business lines and separation of duties throughout the organization. Robust procedures exist for ensuring compliance with applicable laws and regulations, including consumer laws and regulations. Financial, operational, and regulatory reports are reliable, accurate, and timely. Internal audit or other control review practices provide for independence and objectivity. Internal controls and information systems are thoroughly tested and reviewed; the coverage, procedures, findings, and responses to audits and review tests are well documented; identified material weaknesses are given thorough and timely high-level attention; and management’s actions to address material weaknesses are objectively reviewed and verified. The board or its audit committee regularly reviews the effectiveness of internal audits and other control review activities.

*Rating 2 (Satisfactory).* An assessment of “Satisfactory” indicates that the system of internal controls adequately covers major risks and business areas, with some modest weaknesses. In general, the control functions are independent from the business lines, and there is appropriate separation of duties. The control system supports accuracy in record-keeping practices and reporting systems, is adequately documented, and verifies compliance with laws and regulations, including consumer laws and regulations. Internal controls and information systems are adequately tested and reviewed, and the coverage, procedures, findings, and responses to audits and review tests are documented. Identified material weaknesses are given appropriate attention and management’s actions to address material weaknesses are objectively reviewed and verified. The board or its audit committee reviews the effectiveness of internal audits and other control review activities. Any weaknesses or deficiencies that have been identified are modest in nature and in the process of being addressed.

*Rating 3 (Fair).* An assessment of “Fair” signifies that weaknesses exist in the system of internal controls that require more than normal supervisory attention. The weaknesses may involve a broad range of activities or be material

to a major business line or activity. The weaknesses may include insufficient oversight of internal controls and audit by the board or its audit committee; unclear or conflicting lines of authority and responsibility; a lack of independence between control areas and business activities; or ineffective separation of duties. The internal control system may produce inadequate or untimely risk coverage and verification, including monitoring compliance with both safety and soundness and consumer laws and regulations; inaccurate records or financial, operational, or regulatory reporting; a lack of documentation for work performed; or a lack of timeliness in management review and correction of identified weaknesses. Weaknesses noted could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

*Rating 4 (Marginal).* An assessment of “Marginal” represents a deficient internal control system that does not adequately address a number of significant risks to the institution. The deficiencies may include neglect of internal controls and audit by the board or its audit committee; conflicting lines of authority and responsibility; a lack of independence between control areas and business activities; or no separation of duties in critical areas. The internal control system may produce inadequate, untimely, or non-existent risk coverage and verification in certain areas, including monitoring compliance with both safety and soundness and consumer laws and regulations; inaccurate records or financial, operational, or regulatory reporting; a lack of documentation for work performed; or infrequent management review and correction of identified weaknesses. The internal control deficiencies warrant a high degree of supervisory attention because, unless properly addressed, they could seriously affect the safety and soundness of the institution.

*Rating 5 (Unsatisfactory).* An assessment of “Unsatisfactory” indicates a critical absence of an internal control system. There may be no oversight by the board or its audit committee; conflicting lines of authority and responsibility; no distinction between control areas and business activities; or no separation of duties. The internal control system may produce totally inadequate or untimely risk coverage and verification, including monitoring compliance with both safety and soundness and consumer laws and regulations; completely inaccurate records or regulatory reporting; a severe lack of docu-

mentation for work performed; or no management review and correction of identified weaknesses. Such deficiencies require immediate and close supervisory attention, as they could seriously jeopardize the continued viability of the institution.

### 1062.0.7.3 Financial Condition Component

*Rating 1 (Strong).* A rating of 1 indicates that the consolidated holding company is financially sound in almost every respect; any negative findings are basically of a minor nature and can be handled in a routine manner. The capital adequacy, asset quality, earnings, and liquidity of the consolidated holding company are more than adequate to protect the company from reasonably foreseeable external economic and financial disturbances. The company generates more than sufficient cash flow to service its debt and fixed obligations with no harm to subsidiaries of the organization.

*Rating 2 (Satisfactory).* A rating of 2 indicates that the consolidated holding company is fundamentally financially sound, but may have modest weaknesses correctable in the normal course of business. The capital adequacy, asset quality, earnings and liquidity of the consolidated holding company are adequate to protect the company from external economic and financial disturbances. The company also generates sufficient cash flow to service its obligations; however, areas of weakness could develop into areas of greater concern. To the extent minor adjustments are handled in the normal course of business, the supervisory response is limited.

*Rating 3 (Fair).* A rating of 3 indicates that the consolidated holding company exhibits a combination of weaknesses ranging from fair to moderately severe. The company has less than adequate financial strength stemming from one or more of the following: modest capital deficiencies, substandard asset quality, weak earnings, or liquidity problems. As a result, the holding company and its subsidiaries are less resistant to adverse business conditions. The financial condition of the holding company will likely deteriorate if concerted action is not taken to correct areas of weakness. The company’s cash flow is sufficient to meet immediate obligations, but may not remain adequate if action is not taken to correct weaknesses. Consequently, the holding company is vulnerable and requires more than normal supervision. Overall financial

strength and capacity are still such as to pose only a remote threat to the viability of the company.

*Rating 4 (Marginal).* A rating of 4 indicates that the consolidated holding company has either inadequate capital, an immoderate volume of problem assets, very weak earnings, serious liquidity issues, or a combination of factors that are less than satisfactory. An additional weakness may be that the holding company's cash flow needs are met only by upstreaming imprudent dividends and/or fees from subsidiaries. Unless prompt action is taken to correct these conditions, they could impair future viability. Holding companies in this category require close supervisory attention and increased financial surveillance.

*Rating 5 (Unsatisfactory).* A rating of 5 indicates that the volume and character of financial weaknesses of the holding company are so critical as to require urgent aid from shareholders or other sources to prevent insolvency. The imminent inability of such a company to service its fixed obligations and/or prevent capital depletion due to severe operating losses places its viability in serious doubt. Such companies require immediate corrective action and constant supervisory attention.

#### 1062.0.7.3.1 The Financial Condition Subcomponents

The financial condition subcomponents can be evaluated along business lines, product lines, or legal entity lines—depending on which type of review is most appropriate for the holding company structure.

##### Capital Adequacy

*Rating 1 (Strong).* A rating of 1 indicates that the consolidated holding company maintains more than adequate capital to support the volume and risk characteristics of all parent and subsidiary business lines and products; provide a sufficient cushion to absorb unanticipated losses arising from the parent and subsidiary activities; and support the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 1 has more than sufficient capital to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries.

*Rating 2 (Satisfactory).* A rating of 2 indicates that the consolidated holding company

maintains adequate capital to support the volume and risk characteristics of all parent and subsidiary business lines and products; provide a sufficient cushion to absorb unanticipated losses arising from the parent and subsidiary activities; and support the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 2 has sufficient capital to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries.

*Rating 3 (Fair).* A rating of 3 indicates that the consolidated holding company may not maintain sufficient capital to ensure support for the volume and risk characteristics of all parent and subsidiary business lines and products; the unanticipated losses arising from the parent and subsidiary activities; or the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 3 may not maintain a sufficient capital position to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries. The capital position of the consolidated holding company could quickly become inadequate in the event of asset deterioration or other negative factors and therefore requires more than normal supervisory attention.

*Rating 4 (Marginal).* A rating of 4 indicates that the capital level of the consolidated holding company is significantly below the amount needed to ensure support for the volume and risk characteristics of all parent and subsidiary business lines and products; the unanticipated losses arising from the parent and subsidiary activities; and the level and composition of parent and subsidiary borrowing. In addition, a company assigned a rating of 4 does not maintain a sufficient capital position to provide a base for the growth of risk assets and the entry into capital markets as the need arises for the parent company and subsidiaries. If left unchecked, the consolidated capital position of the company might evolve into weaknesses or conditions that could threaten the viability of the institution. The capital position of the consolidated holding company requires immediate supervisory attention.

*Rating 5 (Unsatisfactory).* A rating of 5 indicates that the level of capital of the consolidated holding company is critically deficient and in need of immediate corrective action. The consolidated capital position threatens the viability

of the institution and requires constant supervisory attention.

### Asset Quality

*Rating 1 (Strong).* A rating of 1 indicates that the holding company maintains strong asset quality across all parts of the organization, with a very low level of criticized and nonperforming assets. Credit risk across the organization is commensurate with management's abilities and modest in relation to credit risk-management practices.

*Rating 2 (Satisfactory).* A rating of 2 indicates that the holding company maintains satisfactory asset quality across all parts of the organization, with a manageable level of criticized and nonperforming assets. Any identified weaknesses in asset quality are correctable in the normal course of business. Credit risk across the organization is commensurate with management's abilities and generally modest in relation to credit risk-management practices.

*Rating 3 (Fair).* A rating of 3 indicates that the asset quality across all or a material part of the consolidated holding company is less than satisfactory. The holding company may be facing a decrease in the overall quality of assets currently maintained on and off balance sheet. The holding company may also be experiencing an increase in credit-risk exposure that has not been met with an appropriate improvement in risk-management practices. Holding companies assigned a rating of 3 require more than normal supervisory attention.

*Rating 4 (Marginal).* A rating of 4 indicates that the holding company's asset quality is deficient. The level of problem assets and/or unmitigated credit risk subjects the holding company to potential losses that, if left unchecked, may threaten its viability. Holding companies assigned a rating of 4 require immediate supervisory attention.

*Rating 5 (Unsatisfactory).* A rating of 5 indicates that the holding company's asset quality is critically deficient and presents an imminent threat to the institution's viability. Holding companies assigned a rating of 5 require immediate remedial action and constant supervisory attention.

### Earnings

*Rating 1 (Strong).* A rating of 1 indicates that the quantity and quality of the holding company's consolidated earnings over time are more than sufficient to make full provision for the absorption of losses and/or accretion of capital when due consideration is given to asset quality and holding company growth. Generally, holding companies with a 1 rating have earnings well above peer-group averages.

*Rating 2 (Satisfactory).* A rating of 2 indicates that the quantity and quality of the holding company's consolidated earnings over time are generally adequate to make provision for the absorption of losses and/or accretion of capital when due consideration is given to asset quality and holding company growth. Generally, holding companies with a 2 rating have earnings that are in line with or slightly above peer-group averages.

*Rating 3 (Fair).* A rating of 3 indicates that the holding company's consolidated earnings are not fully adequate to make provisions for the absorption of losses and the accretion of capital in relation to company growth. The consolidated earnings of companies rated 3 may be further clouded by static or inconsistent earnings trends, chronically insufficient earnings, or less than satisfactory asset quality. Holding companies with a 3 rating generally have earnings below peer-group averages. Such holding companies require more than normal supervisory attention.

*Rating 4 (Marginal).* A rating of 4 indicates that the holding company's consolidated earnings, while generally positive, are clearly not sufficient to make full provision for losses and the necessary accretion of capital. Holding companies with earnings rated 4 may be characterized by erratic fluctuations in net income, poor earnings (and the likelihood of the development of a further downward trend), intermittent losses, chronically depressed earnings, or a substantial drop from the previous year. The earnings of such companies are generally substantially below peer-group averages. Such holding companies require immediate supervisory attention.

*Rating 5 (Unsatisfactory).* A rating of 5 indicates that the holding company is experiencing losses or a level of earnings that is worse than that described for the 4 rating. Such losses, if not reversed, represent a distinct threat to the holding company's solvency through erosion of capital. Such holding companies require immediate and constant supervisory attention.

## Liquidity

**Rating 1 (Strong).** A rating of 1 indicates that the holding company maintains strong liquidity levels and well-developed funds-management practices. The parent company and subsidiaries have reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

**Rating 2 (Satisfactory).** A rating of 2 indicates that the holding company maintains satisfactory liquidity levels and funds-management practices. The parent company and subsidiaries have access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses in funds-management practices may be evident, but those weaknesses are correctable in the normal course of business.

**Rating 3 (Fair).** A rating of 3 indicates that the holding company's liquidity levels or funds-management practices are in need of improvement. Holding companies rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds-management practices at the parent company or subsidiary levels. However, these deficiencies are considered correctable in the normal course of business. Such holding companies require more than normal supervisory attention.

**Rating 4 (Marginal).** A rating of 4 indicates that the holding company's liquidity levels or funds-management practices are deficient. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs at the parent company or subsidiary levels and require immediate supervisory attention.

**Rating 5 (Unsatisfactory).** A rating of 5 indicates that the holding company's liquidity levels or funds-management practices are critically deficient and may threaten the continued viability of the institution. Institutions rated 5 require constant supervisory attention and immediate external financial assistance to meet maturing obligations or other liquidity needs.

1—low likelihood of significant negative impact;

2—limited likelihood of significant negative impact;

3—moderate likelihood of significant negative impact;

4—considerable likelihood of significant negative impact; and

5—high likelihood of significant negative impact.

**Rating 1 (Low Likelihood of Significant Negative Impact).** A rating of 1 indicates that the nondepository entities of the holding company are highly unlikely to have a significant negative impact on the subsidiary depository institution(s) due to the sound financial condition of the nondepository entities, the strong risk-management practices within the nondepository entities, or the corporate structure of the holding company. The holding company maintains an appropriate capital allocation across the organization commensurate with associated risks. Intra-group exposures, including servicing agreements, are very unlikely to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow is sufficient and not dependent on excessive dividend payments from subsidiaries. The potential risks posed to the subsidiary depository institution(s) by strategic plans, the control environment, risk concentrations, or legal or reputational issues within or facing the nondepository entities are minor in nature and can be addressed in the normal course of business.

**Rating 2 (Limited Likelihood of Significant Negative Impact).** A rating of 2 indicates a limited likelihood that the nondepository entities of the holding company will have a significant negative impact on the subsidiary depository institution(s) due to the adequate financial condition of the nondepository entities, the satisfactory risk-management practices within the parent nondepository entities, or the corporate structure of the holding company. The holding company maintains adequate capital allocation across the organization commensurate with associated risks. Intra-group exposures, including servicing agreements, are unlikely to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow is satisfactory and generally does not require excessive dividend payments from subsidiaries. The potential risks posed to the subsidiary depository institution(s) by strategic plans, the control

### 1062.0.7.4 Impact Component

The I component rating reflects the aggregate potential impact of the nondepository entities on the subsidiary depository institution(s). It is rated on a five-point numerical scale. Ratings will be assigned in ascending order of supervisory concern as follows:

environment, risk concentrations, or legal or reputational issues within the nondepository entities are modest and can be addressed in the normal course of business.

*Rating 3 (Moderate Likelihood of Significant Negative Impact).* A rating of 3 indicates a moderate likelihood that the aggregate impact of the nondepository entities of the holding company on the subsidiary depository institution(s) will have a significant negative impact on the subsidiary depository institution(s) due to weaknesses in the financial condition and/or risk management practices of the nondepository entities. The holding company may have only marginally sufficient allocation of capital across the organization to support risks. Intra-group exposures, including servicing agreements, may have the potential to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow may at times require excessive dividend payments from subsidiaries. Strategic growth plans, weaknesses in the control environment, risk concentrations or legal or reputational issues within the nondepository entities may pose significant risks to the subsidiary depository institution(s). A holding company assigned a 3 impact rating requires more than normal supervisory attention, as there could be adverse effects on the safety and soundness of the subsidiary depository institution(s) if corrective action is not taken by management.

*Rating 4 (Considerable Likelihood of Significant Negative Impact).* A rating of 4 indicates that there is a considerable likelihood that the nondepository entities of the holding company will have a significant negative impact on the subsidiary depository institution(s) due to weaknesses in the financial condition and/or risk-management practices of the nondepository entities. A 4-rated holding company may have insufficient capital within the nondepository entities to support their risks and activities. Intra-group exposures, including servicing agreements, may also have the immediate potential to undermine the financial condition of the subsidiary depository institution(s). Parent company cash flow may be dependent on excessive dividend payments from subsidiaries. Strategic growth plans, weaknesses in the control environment, risk concentrations or legal or reputational issues within the nondepository entities may pose considerable risks to the subsidiary depository institution(s). A holding company assigned a 4 impact rating requires immediate remedial action and close supervisory attention

because the nondepository entities could seriously affect the safety and soundness of the subsidiary depository institution(s).

*Rating 5 (High Likelihood of Significant Negative Impact).* A rating of 5 indicates a high likelihood that the aggregate impact of the non-depository entities of the holding company on the subsidiary depository institution(s) is or will become significantly negative due to substantial weaknesses in the financial condition and/or risk-management practices of the nondepository entities. Strategic growth plans, a deficient control environment, risk concentrations or legal or reputational issues within the nondepository entities may pose critical risks to the subsidiary depository institution(s). The parent company also may be unable to meet its obligations without excessive support from the subsidiary depository institution(s). The holding company requires immediate and close supervisory attention, as the nondepository entities seriously jeopardize the continued viability of the subsidiary depository institution(s).

#### 1062.0.7.5 (D) Depository Institutions Component

The (D) component identifies the overall condition of the subsidiary depository institution(s) of the holding company. For holding companies with only one subsidiary depository institution, the (D) component rating generally will mirror the CAMELS composite rating for that depository institution. To arrive at a (D) component rating for holding companies with multiple subsidiary depository institutions, the CAMELS composite ratings for each of the depository institutions should be weighted, giving consideration to asset size and the relative importance of each depository institution within the overall structure of the organization. In general, it is expected that the resulting (D) component rating will reflect the lead depository institution's CAMELS composite rating.

If in the process of analyzing the financial condition and risk-management programs of the consolidated organization, a major difference of opinion regarding the safety and soundness of the subsidiary depository institution(s) emerges between the Federal Reserve and the depository institution's primary regulator, then the (D) rating should reflect the Federal Reserve's evaluation.

# Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$100 Billion

## Section 1062.1

Managing risks is fundamental to the business of banking. Accordingly, the Federal Reserve places significant supervisory emphasis on an institution's management of risk, including its system of internal controls, when evaluating the overall effectiveness of an institution's risk management. An institution's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks of its activities has long been considered unsafe-and-unsound conduct. Principles of sound management should apply to the entire spectrum of risks facing an institution including, but not limited to, credit, market, liquidity, operational, compliance, and legal risk:

- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Market risk* is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, including, but not limited to, interest rates, foreign exchange rates, commodity prices, or equity prices.
- *Liquidity risk* is the potential that a financial institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as "market liquidity risk").
- *Operational risk* is the risk resulting from inadequate or failed internal processes, people, and systems or from external events.<sup>1</sup>
- *Compliance risk* is the risk of regulatory sanctions, fines, penalties or losses resulting from failure to comply with laws, rules, regulations, or other supervisory requirements applicable to a financial institution.
- *Legal risk* is the potential that actions against the institution that result in unenforceable contracts, lawsuits, legal sanctions, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a financial institution.

The risk-management expectations outlined in this guidance are applicable to all supervised institutions with total consolidated assets less than \$100 billion, including state member banks, bank holding companies, savings and loan holding companies, and foreign banking organizations with combined total U.S. assets of less than \$100 billion. This guidance also applies to insurance and commercial savings and loan holding companies with total consolidated assets less than \$100 billion by providing core risk-management guidance. Reserve Bank staff may further consult with Board staff on appropriately tailoring this guidance for these institutions. This guidance is not applicable to intermediate holding companies of foreign banking organizations established pursuant to the Federal Reserve's Regulation YY with total consolidated assets of \$50 billion or more.

These risks and the activities associated with them are addressed in greater detail in the Federal Reserve's supervision manuals and other guidance documents.<sup>2</sup> In practice, an institution's business activities present various combinations, concentrations, and interrelationships of these risks depending on the nature and scope of the particular activity. The following discussion provides guidelines for the supervisory assessment of the overall effectiveness of an institution's risk management and its formal or informal systems for identifying, measuring, monitoring, and controlling these risks. Refer to [SR-16-11](#) and its attachment.

### 1062.1.1 ELEMENTS OF RISK MANAGEMENT

When evaluating the risk management at an institution as part of the evaluation of the overall effectiveness of management, examiners should place primary consideration on findings relating to the following elements of a sound risk-management system:

2. Refer to the Federal Reserve's *Commercial Bank Examination Manual*, this *Bank Holding Company Supervision Manual*, *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*, and relevant FFIEC Examination Manuals.

1. This definition conforms to the Basel Committee on Banking Supervision's "Principles for the Sound Management of Operational Risk," June 2011, Bank for International Settlements.

- board<sup>3</sup> and senior management oversight
- policies, procedures, and limits
- risk monitoring and management information systems
- internal controls

Each of these elements is described further below, along with a list of considerations relevant to assessing each element. Examiners should recognize that the considerations specified in these guidelines are intended only to assist in the evaluation of risk-management practices and are not a checklist of requirements for each institution.

An institution's risk-management processes are expected to evolve in sophistication, commensurate with the institution's asset growth, complexity, and risk. At a larger or more complex organization, the institution should have more sophisticated risk-management processes that address the full range of risks regardless of where the activity is conducted in the organization. Moreover, while a holding company should be able to assess the major risks of the consolidated organization, examiners should expect a parent company that centrally manages the operations and functions of its subsidiary banks to have more comprehensive, detailed, and developed risk-management systems than a parent company that delegates the management of risks to relatively autonomous subsidiaries.<sup>4</sup>

For a small community banking organization (CBO) engaged solely in traditional banking activities and whose senior management is actively involved in the details of day-to-day operations, relatively basic risk-management systems may be adequate. In accordance with the *Interagency Guidelines Establishing Standards for Safety and Soundness*, a CBO is expected, at a minimum, to have internal controls, information systems, and internal audits that are appropriate for the size of the institution and the nature, scope, and risk of its activities.<sup>5</sup>

3. For the purpose of this guidance, for foreign banking organizations, "board of directors" refers to the equivalent governing body of the U.S. operations of the FBO.

4. If these subsidiaries are regulated by another federal banking agency, Federal Reserve examiners should rely to the fullest extent possible on the conclusions drawn by relevant regulators regarding risk management. See also, [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."

5. Refer to 12 CFR 208, Appendix D-1, the *Interagency Guidelines Establishing Standards for Safety and Soundness*.

The risk-management processes of a regional banking organization (RBO) would typically contain detailed guidelines that set specific prudent limits on the principal types of risks relevant to a RBO's consolidated activities.<sup>6</sup> Furthermore, because of the diversity and the geographic dispersion of their activities, these institutions will require relatively more sophisticated information systems that provide management with timely information that supports the management of risks. The information systems, in turn, should provide management with information that present a consolidated and integrated view of risks that are relevant to the duties and responsibilities of individual managers, senior management, and the board of directors.<sup>7</sup>

Consistent with the principle of national treatment,<sup>8</sup> the Federal Reserve has the same supervisory goals and standards for the U.S. operations of FBOs as for domestic organizations of similar size, scope, and complexity. Given the added element of foreign ownership, an FBO's risk-management processes and control functions for the U.S. operations may be implemented domestically or outside of the United States. In cases where these functions are performed outside of the United States, the FBO's oversight function, policies and procedures, and information systems need to be sufficiently transparent to allow U.S. supervisors to assess their adequacy. Additionally, the FBO's U.S. senior management need to demonstrate and maintain a thorough understanding of all relevant risks affecting the U.S. operations and the associated management information systems, used to manage and monitor these risks within the U.S. operations.

The information systems at a larger institution will naturally require frequent monitoring and testing by independent control areas and by both internal and external auditors, to ensure the integrity of the information used by the board of directors and senior management in overseeing compliance with policies and limits. Therefore,

6. The Federal Reserve considers an RBO to be a midsize financial institution with total consolidated assets between \$10 and \$100 billion.

7. Subpart C of the Federal Reserve's Regulation YY includes risk committee requirements for bank holding companies with total consolidated assets between \$50 billion and \$100 billion.

8. National treatment requires nondiscrimination between domestic and foreign firms, or treatment of foreign entities that is no less favorable than that accorded to domestic enterprises in like circumstances. The International Banking Act of 1978 generally gives foreign banks operating in the United States the same powers as domestic banking organizations and subjects them to the same restrictions and obligations.

an institution's risk oversight function needs to be sufficiently independent of the business lines to achieve an adequate separation of duties and the avoidance of conflicts of interest.

#### 1062.1.1.1 Board and Senior Management Oversight

The board of directors has the responsibility for establishing the level of risk that the institution should take. Accordingly, the board of directors should approve the institution's overall business strategies and significant policies, including those related to managing risks. Further, the board of directors should also ensure that senior management is fully capable of implementing the institution's business strategies and risk limits. In evaluating senior management, the board of directors should consider whether management is taking the steps necessary to identify, measure, monitor, and control these risks.

The board of directors should collectively have a balance of skills, knowledge, and experience to clearly understand the activities and risks to which the institution is exposed. The board of directors should take steps to develop an appropriate understanding of the risks the institution faces, through briefings from experts internal to their organization and potentially from external experts. The institution's management information systems should provide the board of directors with sufficient information to identify the size and significance of the risks. Using this knowledge and information, the board of directors should provide clear guidance regarding the level of exposures acceptable to the institution and oversee senior management's implementation of the procedures and controls necessary to comply with approved policies.

Senior management is responsible for implementing strategies set by the board of directors in a manner that controls risks and that complies with laws, rules, regulations, or other supervisory requirements on both a long-term and day-to-day basis. Accordingly, senior management should be fully involved in and possess sufficient knowledge of all activities to ensure that appropriate policies, controls, and risk monitoring systems are in place and that accountability and lines of authority are clearly delineated. Senior management is also responsible for establishing and communicating a strong awareness of the need for effective risk management, internal controls, and high ethical business practices. To fulfill these responsibilities, senior management needs to have a thorough understanding of banking and financial market activities and de-

tailed knowledge of the institution's activities, including the internal controls that are necessary to limit the related risks.

In assessing the quality of the oversight provided by the board of directors and senior management, examiners should consider the following:

- The board of directors has approved significant policies to establish risk tolerances for the institution's activities and periodically reviews risk exposure limits to align with changes in the institution's strategies, address new activities and products, and react to changes in the industry and market conditions.
- Senior management has identified and has a clear understanding and working knowledge of the risks inherent in the institution's activities. Senior management also remains informed about these risks as the institution's business activities evolve or expand and as changes and innovations occur in financial markets and risk-management practices.
- Senior management has identified and reviewed risks associated with engaging in new activities or introducing new products to ensure that the necessary infrastructure and internal controls are in place to manage the related risks.
- Senior management has ensured that the institution's activities are managed and staffed by personnel with the knowledge, experience, and expertise consistent with the nature and scope of the institution's activities and risks.
- All levels of senior management provide appropriate management of the day-to-day activities of officers and employees, including oversight of senior officers or heads of business lines.
- Senior management has established and maintains effective information systems to identify, measure, monitor, and control the sources of risks to the institution.

#### 1062.1.1.2 Policies, Procedures, and Limits

Although an institution's board of directors approves an institution's overall business strategy and policy framework, senior management develops and implements the institution's risk-management policies and procedures that address the types of risks arising from its activities. Once the risks are properly identified, the insti-

tution’s policies and procedures should provide guidance for the day-to-day implementation of business strategies, including limits designed to prevent excessive and imprudent risks. An institution should have policies and procedures that address its significant activities and risks with the appropriate level of detail to address the type and complexity of the institution’s operations. A smaller, less complex institution that has effective senior management directly involved in day-to-day operations would generally not be expected to have policies as sophisticated as larger institutions. In a larger institution, where senior managers rely on widely-dispersed staffs to implement strategies for more varied and complex businesses, far more detailed policies and procedures would generally be expected. In either case, senior management is expected to ensure that policies and procedures address the institution’s material areas of risk and that policies and procedures are modified when necessary to respond to significant changes in the institution’s activities or business conditions.

The following guidelines should assist examiners in evaluating an institution’s policies, procedures, and limits

- The institution’s policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its significant risk-taking activities.
- The institution’s policies, procedures, and limits are consistent with its stated strategy and risk profile.
- The policies and procedures establish accountability and lines of authority across the institution’s activities.
- The policies and procedures provide for the review and approval of new business lines, products, and activities, as well as material modifications to existing activities, services, and products, to ensure that the institution has the infrastructure necessary to identify, measure, monitor, and control associated risks before engaging in a new or modified business line, product, or activity.

1062.1.1.3 Risk Monitoring and Management Information Systems

Institutions of all sizes are expected to have risk monitoring and management information systems in place that provide the board of directors and senior management with timely information

and a clear understanding of the institution’s business activities and risk exposures. The sophistication of risk monitoring and management information systems should be commensurate with the complexity and diversity of the institution’s operations. Accordingly, a smaller and less complex institution may require less frequent management and board reports to support risk monitoring activities. For example, these reports may include, daily or weekly balance sheets and income statements, a watch list for potentially troubled loans, a report on past due loans, an interest rate risk report, and similar items. In contrast, a larger, more complex institution would be expected to have much more comprehensive reporting and monitoring systems, which includes more frequent reporting to board and senior management, tighter monitoring of high-risk activities, and the ability to aggregate risks on a fully consolidated basis across all business lines, legal entities, and activities.

In assessing an institution’s measurement and monitoring of risk and its management reports and information systems, examiners should consider whether these conditions exist:

- The institution’s risk monitoring practices and reports address all of its material risks.
- Key assumptions, data sources, models, and procedures used in measuring and monitoring risks are appropriate and adequately documented and tested for reliability on an ongoing basis.<sup>9</sup>
- Reports and other forms of communication address the complexity and range of an institution’s activities, monitor key exposures and compliance with established limits and strategy, and as appropriate, compare actual versus expected performance.
- Reports to the board of directors and senior management are accurate, and provide timely and sufficient information to identify any adverse trends and to evaluate the level of risks faced by the institution.

1062.1.1.4 Internal Controls

An effective internal control structure is critical to the safe and sound operation of an institution. Effective internal controls promote reliable financial and regulatory reporting, safeguard assets, and help to ensure compliance with relevant laws, rules, regulations, supervisory require-

<sup>9</sup> See also [SR-11-7](#), “Guidance on Model Risk Management.”

ments, and institutional policies. Therefore, an institution's senior management is responsible for establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate segregation of duties.

Adequate segregation of duties is a fundamental and essential element of a sound risk management and internal control system. Failure to implement and maintain an adequate segregation of duties can constitute an unsafe-and-unsound practice and possibly lead to serious losses or otherwise compromise the integrity of the institution's internal controls. Serious lapses or deficiencies in internal controls, including inadequate segregation of duties, may warrant supervisory action, including formal enforcement action.

Internal controls should be tested by an independent party who reports either directly to the institution's board of directors or its designated committee, which is typically the audit committee.<sup>10</sup> However, small CBOs whose size and complexity do not warrant a full scale internal audit function may rely on regular reviews of essential internal controls conducted by other institution personnel. Given the importance of appropriate internal controls to institutions of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management's responses to the findings. In addition, communication channels should allow for adverse or sensitive findings to be reported directly to the board of directors or to the relevant board committee.

In evaluating internal controls, examiners should consider whether these conditions are met:

- The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the institution's activities.
- The institution's organizational structure establishes clear lines of authority and responsibility for risk management and for monitoring adherence to policies, procedures, and limits.
- Internal audit or other control functions, such as loan review and compliance, provide for independence and objectivity.

- The official organizational structures reflect actual operating practices and management responsibilities and authority over a particular business line or activity.
- Financial, operational, risk management, and regulatory reports are reliable, accurate, and timely; and wherever applicable, material exceptions are noted and promptly investigated or remediated.
- Policies and procedures for control functions support compliance with applicable laws, rules, regulations, or other supervisory requirements.
- Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits, regulatory examinations, and other review tests are adequately documented; identified material weaknesses are given appropriate and timely, high-level attention; and management's actions to address material weaknesses are objectively verified and reviewed.
- The institution's board of directors, or audit committee, and senior management are responsible for developing and implementing an effective system of internal controls and that the internal controls are operating effectively.

### 1062.1.1.5 Conclusions

Examiners are expected to assess risk management for an institution and assign formal ratings of "risk management" as described in the *Commercial Bank Examination Manual* for state member banks, this manual for holding companies, and the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*.<sup>11</sup> In reports of examination or inspection, and in transmittal letters to the boards of directors of state member banks, holding companies,<sup>12</sup> and to the FBO officer of the U.S. operations, examination staff should specifically

11. Refer to section 1200.1 of the *Commercial Bank Examination Manual*; section 1062.0 of the *Bank Holding Company Supervision Manual*; and section 2003.1 of the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*. For savings and loan holding companies, see also [SR-14-9](#), "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program."

12. [SR-16-11](#) applies to insurance and commercial savings and loan holding companies with total consolidated assets less than \$100 billion by providing core risk-management guidance. Reserve Bank staff should further consult with Board staff on appropriately tailoring this guidance for these institutions.

10. Given the importance of the internal audit function, several additional policy statements have been issued. For comprehensive guidance on internal audit, see [SR-03-5](#), "Amended Interagency Guidance on the Internal Audit Function and its Outsourcing" and for institutions with more than \$10 billion in assets, see [SR-13-1/ CA-13-1](#), "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing."

reference the types and nature of corrective actions that need to be taken by an institution to address noted risk management and internal control deficiencies. Where appropriate, the Federal Reserve will advise an institution that supervisory action will be initiated, if the institution fails to timely remediate risk-management weaknesses when such failures create the potential for serious losses or if material deficiencies or situations threaten its safety and soundness. Such supervisory actions may include formal enforcement actions against the institution, or its responsible officers and directors, or both,

and would require the immediate implementation of all necessary corrective measures.

If bank or holding company subsidiaries are regulated by another federal banking agency, Federal Reserve examiners should rely to the fullest extent possible on the conclusions drawn by relevant regulators regarding risk management. See also, 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.”

The purpose of this section is to provide an overview of the inspection scope and frequency expectations for bank holding companies (BHCs) and savings and loan holding companies (SLHCs) supervised by the Federal Reserve. The Federal Reserve utilizes different rating systems to assess these and other holding companies.

BHCs and non-insurance, non-commercial SLHCs with total consolidated assets of \$100 billion or more generally are subject to the large financial institution (LFI) rating system. (See section 1060.0 of this manual.) U.S. intermediate holding companies of foreign banking organizations with combined U.S. assets of \$50 billion or more established pursuant to the Federal Reserve's Regulation YY are also subject to the LFI rating system.

BHCs and non-insurance and non-commercial SLHCs with less than \$100 billion in total consolidated assets generally are subject to the RFI rating system. (See section 1062.0 of this manual.) However, noncomplex holding companies with less than \$3 billion in total

consolidated assets only receive the risk-management rating and composite rating from the RFI rating system.

BHCs exempt from the prohibitions of section 4 of the Bank Holding Company Act of 1956, as amended, as a result of any of the following exemptions, will not be subject to any required periodic inspection:

1. section 4(a)(2)—permanent grandfather rights
2. section 4(c)(i)—labor, agricultural, or horticultural organization
3. section 4(c)(ii)—85 percent family-owned
4. section 4(c)(12)—irrevocable declaration to cease to be a BHC
5. section 4(d)—hardship exemption

However, the Reserve Bank should continue to monitor the financial condition of such holding companies and should conduct inspections whenever there is any indication of a potential problem in a subsidiary bank.

1063.0.1 RATING SYSTEMS FOR HOLDING COMPANIES

Rating System	Rating System Components	Applicability
LFI rating (SR-19-3/CA-19-2)	<ul style="list-style-type: none"><li>• Capital planning and positions</li><li>• Liquidity risk management and positions</li><li>• Governance and controls</li></ul>	<ul style="list-style-type: none"><li>• BHCs with total consolidated assets of \$100 billion or more</li><li>• Non-insurance, non-commercial SLHCs with total consolidated assets of \$100 billion or more</li><li>• U.S. intermediate holding companies of foreign banking organizations with combined U.S. assets of \$50 billion or more established under the Board’s Regulation YY</li></ul>
RFI rating (SR-19-4/CA-19-3)	<ul style="list-style-type: none"><li>• Risk management (4 subcomponents)<ul style="list-style-type: none"><li>○ Board and senior management oversight,</li><li>○ Policies, procedures, and limits,</li><li>○ Risk monitoring and management information systems, and</li><li>○ Internal controls</li></ul></li><li>• Financial condition (4 subcomponents)<ul style="list-style-type: none"><li>○ Capital,</li><li>○ Asset quality,</li><li>○ Earnings, and</li><li>○ Liquidity</li></ul></li><li>• Impact</li><li>• Composite rating</li><li>• Depository institutions</li></ul>	<ul style="list-style-type: none"><li>• BHCs with \$3 billion or more and less than \$100 billion in total consolidated assets</li><li>• Non-insurance and non-commercial SLHCs with \$3 billion or more and less than \$100 billion in total consolidated assets</li><li>• Complex BHCs and complex non-insurance and non-commercial SLHCs with less than \$3 billion in total consolidated assets</li></ul>
Modified RFI rating (SR-13-21)	<ul style="list-style-type: none"><li>• Risk-management (no subcomponents)</li><li>• Composite rating</li></ul>	Noncomplex BHCs and noncomplex non-insurance and non-commercial SLHCs with less than \$3 billion in total consolidated assets
Supervised insurance organization rating (SR-22-8)	<ul style="list-style-type: none"><li>• Governance and controls,</li><li>• Capital management, and</li><li>• Liquidity management</li></ul>	Supervised insurance organizations <sup>1</sup>
Indicative RFI rating	Indicates to the firm how it would be rated if the RFI rating system was formally applied.	Commercial SLHCs <sup>2</sup>

1. A supervised insurance organization is a depository institution holding company that is an insurance underwriting company, or that has over 25 percent of its consolidated assets held by insurance underwriting subsidiaries or has been otherwise designated as a supervised insurance organization by Federal Reserve staff.

2. SLHCs are considered to be “commercial SLHCs” if they derive 50 percent or more of their total consolidated assets or total revenues from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956, as amended (12 USC 1843(k)).

1063.0.2 GENERAL INSPECTION FREQUENCY FOR A HOLDING COMPANY

	Total consolidated asset size				
Type of holding company	\$100 billion or more	\$10 billion or more and less than \$100 billion	\$3 billion or more and less than \$10 billion	Less than \$3 billion (complex)	Less than \$3 billion (non-complex)
Bank holding company <sup>1</sup>	Ratings (or indicative ratings) assigned and communicated to firms on at least an <b>annual</b> basis, and more frequently as warranted.		See the table below and <a href="#">SR letter 13-21</a> , and its <a href="#">attachment</a> for more information on inspection frequency and scope.		
Non-insurance and non-commercial savings and loan holding company					
Commercial savings and loan holding company					
Intermediate holding company	U.S. intermediate holding companies of foreign banking organizations established under the Board’s Regulation YY that have \$50 billion or more in total consolidated assets are assigned an LFI rating on at least an <b>annual</b> basis, and more frequently as warranted.				
Supervised insurance organization	“Complex” supervised insurance organizations are assigned ratings on an <b>annual</b> basis. <sup>3</sup> Noncomplex supervised insurance organizations are assigned ratings <b>no less often than every other year</b> .				

1. BHCs exempt from the prohibitions of section 4 of the Bank Holding Company Act of 1956, as amended, are not subject to any required periodic inspection.

2. SLHCs are considered to be “commercial savings and loan holding companies” if they derive 50 percent or more of their total consolidated assets or total revenues from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956, as amended (12 USC 1843(k)).

3. A supervised insurance organization is automatically classified as “complex” if its depository institution’s average assets exceed \$100 billion.

## 1063.0.3 Small Holding Company Inspection Scope and Frequency

Asset size		\$3 billion or more and less than \$10 billion		Less than \$3 billion	
Complexity <sup>2</sup>		Complex	Noncomplex	Complex	Noncomplex
Type of rating		Complete RFI rating	Complete RFI rating	Complete RFI rating	Risk-management rating and composite rating only
Scope and frequency <sup>1</sup>	Rating of 1 or 2	<b>Full scope on-site</b> inspection is expected <b>annually</b> .  Additional targeted follow-up may be needed in response to off-site surveillance program results.	<b>Off-site targeted</b> inspection is expected every <b>two years</b> .  Additional targeted follow-up may be needed in response to off-site surveillance program results.	<b>Off-site review</b> should be conducted <b>upon receipt of the lead DI exam report or an updated rating</b> from the primary supervisor using surveillance results and relevant supervisory and financial information. If the information obtained off-site is not sufficient for the Reserve Bank to determine the overall condition of the company and to assign a complete RFI rating, the Reserve Bank should conduct an on-site review of the company.  Any on-site review should be targeted at those areas where additional information or analysis is needed to assign a complete supervisory rating.	If all subsidiary DIs have a management component rating and a composite supervisory rating of “1” or “2” and no material holding company issues are otherwise indicated, the Reserve Bank should <b>assign only a composite rating and risk-management rating to the holding company based on the ratings of the lead DI</b> .
	Rating of 3, 4, or 5	<b>Full scope on-site</b> inspection is expected <b>annually</b> .  If the primary supervisor has conducted an interim examination or changed the rating at the lead depository institution (DI), the Reserve Bank should conduct an additional targeted inspection and update the rating if necessary. The targeted inspection may be conducted off-site and should start within 60 days of receiving the examination report for the lead DI.  Additional targeted follow-up may be needed in response to off-site surveillance program results.	<b>Full-scope off-site</b> inspection is expected <b>annually</b> .  If the primary supervisor has conducted an interim examination or changed the rating at the lead DI, the Reserve Bank staff should conduct an additional targeted inspection and update the rating if necessary. This targeted inspection may be conducted off-site and should start within 60 days of receiving the examination report for the lead DI.  Additional targeted follow-up may be needed in response to off-site surveillance program results.		If one or more subsidiary DIs have a management component rating or a composite supervisory rating of “3,” “4,” or “5” or a material holding company issue is otherwise indicated, an <b>off-site review</b> is expected <b>upon receipt of the lead DI exam report or an updated rating</b> from the primary supervisor using surveillance results and relevant supervisory and financial information. If the information obtained off-site is not sufficient for the Reserve Bank to determine the overall condition of the company and to assign a risk-management rating and a composite rating, contact the holding company to obtain more information.
Report expectations	Rating of 1, 2, or 3	A letter-format report template has been developed for supervision staff completing reports for holding companies that receive a complete RFI rating and have a composite rating of 1, 2, or 3.			Off-site reviews culminate in the issuance of a transmittal letter communicating the ratings to the company. Information in the transmittal letter review focuses on parent and nonbanking activities. Examiners also rely on the primary regulator’s work on the subsidiary insured depository institution and relevant surveillance results.
	Rating of 4 or 5	Letter-format report of inspection may be prepared as indicated in the Community Bank Supervision Process section of the <i>Commercial Bank Examination Manual</i> .			

1. Full-scope inspection covers all areas of interest to the Federal Reserve in depth; targeted inspections will focus intensely on one or two activities.
2. Complexity factors include the size and structure of the company; the extent of intercompany transactions between insured depository institution subsidiaries and the holding company or uninsured subsidiaries of the holding company; the risk, scale and complexity of activities of any nondepository subsidiaries; and the degree of leverage at the holding company, including the extent of its debt outstanding to the public. Other factors are also noted in the text of SR-13-21.

# Nondisclosure of Supervisory Ratings and Confidential Supervisory Information

## Section 1065.0

### 1065.0.1 LIMITED DISCLOSURE OF CONFIDENTIAL COMPOSITE AND COMPONENT RATINGS IN INSPECTIONS AND EXAMINATIONS

The Federal Reserve provides senior management and directors of supervised financial institutions the numeric and alphabetic component ratings assigned under various supervisory rating systems.<sup>1</sup> (See [SR-96-26](#), “Provision of Individual Components of Supervisory Rating Systems to Management and Boards of Directors.”) This disclosure includes the ratings assigned to management under the holding company rating systems.<sup>2</sup>

Depending upon the size and complexity of the organization, the disclosure of the rating and its components is made to the holding company in writing through formal examination or inspection reports, reports summarizing the results of targeted reviews, a roll-up of those reviews into a comprehensive report, any other supervisory communication, or some combination thereof. In conjunction with disclosing the ratings and their components to a holding company, examiners or supervisory officials should clearly explain what the ratings mean to the board of directors and management. During the exit meeting, the examiner should discuss key overall inspection findings, including preliminary composite and component numeric ratings.

In disclosing the assigned ratings, the examiner-in-charge should remind the board of directors and management that the ratings are part of the findings of the inspection or supervisory activity and are privileged and confidential under applicable law.<sup>3</sup> When examiners change a firm’s ratings, examiners need to inform the firm’s board of directors and management about the rating change. Examiners should not disclose

ratings to the holding company’s directors and management until preliminary approval has been received from the appropriate senior Reserve Bank supervisory officials.

### 1065.0.2 CONFIDENTIALITY OF THE SUPERVISORY RATING AND OTHER NONPUBLIC SUPERVISORY INFORMATION

The holding company inspection report and other supervisory communications constitute or contain the Board’s confidential supervisory information (CSI), which is nonpublic information belonging to the Board.<sup>4</sup> The Board’s Rules Regarding Availability of Information specifically provide that, except in very limited circumstances, supervised financial institutions may not disclose CSI outside of the financial institution, including inspection or examination findings, nor make any representations concerning an examination or inspection report or the report’s findings, without the prior written permission of the Board.<sup>5</sup> Any person who discloses or uses CSI except as expressly permitted by the appropriate federal banking agency or as provided by the agency’s regulations may be subject to the criminal penalties provided in 18 USC 641.

The legal prohibition on the release of CSI applies to all financial institutions examined by the agencies, including bank and savings and loan holding companies, Edge corporations, and the U.S. branches or agencies of foreign banking organizations that receive confidential supervisory ratings, including the LFI rating, RFI/C(D) rating, ROCA rating, and CAMEO rating.<sup>6</sup> As

1. The supervisory ratings are disclosed for the following rating systems:

- CAMELS (state member banks)
- RFI/C(D) and Large Financial Institution (LFI) rating system (bank holding companies, and savings and loan holding companies)
- CAMEO (Edge and agreement corporations and overseas subsidiaries of U.S. banks)
- ROCA (U.S. branches and agencies of foreign banking organizations)
- Uniform Interagency Trust Rating System (UITRS)
- The interagency Uniform Rating System for Information Technology (URISIT)

2. See [SR-19-3 / CA-19-2](#), “Large Financial Institution (LFI) Rating System” and [SR-19-4 / CA-19-3](#), “Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than \$100 billion.”

3. The inspection report should also include appropriate language stating that the findings of the inspection are privileged and confidential under applicable law.

4. See, e.g., 12 CFR 261.2(c)(1), 261.20(g), and 261.22(e).

5. 12 CFR part 261, subpart C. The regulation authorizes supervised financial institutions to disclose CSI to their directors, officers, and employees and to the directors, officers, and employees of their parent holding companies. 12 CFR 261.20(b)(1). In addition, institutions may also disclose CSI to their outside counsel and auditors on the premises of the institution. 12 CFR 261.20(b)(2).

6. RFI/C(D), LFI, ROCA, and CAMEO ratings are assigned by the Federal Reserve Board as a result of an examination or inspection. For noncomplex holding companies with assets of \$3 billion or less, only risk-management and composite ratings are assigned. ROCA ratings are assigned to the U.S. branches, agencies, and commercial lending companies of foreign banking organizations. The ROCA rating components are risk management, operational controls, compliance,

with the CAMELS rating, examiners communicate these ratings to the regulated institutions in reports or other supervisory communications, which are the property of the Board.

Financial institutions that receive requests for confidential supervisory ratings should refer all requesters to the following publicly available information in lieu of disclosing any CSI, including the CAMELS rating:

- for banks and savings associations, an institution's quarterly reports of condition (Call Reports) (see 12 USC 1817)
- for holding companies or foreign banks with U.S. operations, an institution's quarterly and annual FR Y or H-(b)11 reports (see 12 USC 1844, 3106, 3108, 601–604a, and 611–631)
- for national banks, the annual disclosure statement (see 12 CFR 18.3)
- for banks, an institution's Uniform Bank Performance Report (UBPR), which is available to all interested parties at [www.ffiec.gov](http://www.ffiec.gov) and is designed for summary and in-depth analysis of banks;
- an institution's publicly available filings, if any, filed with the appropriate federal banking agency (15 USC 78(I)(i)) or with the U.S. Securities and Exchange Commission
- any reports or ratings on the institution compiled by private companies that track the performance of financial institutions
- any reports or ratings issued by private rating services on public debt issued by an institution
- any publicly available cease-and-desist order or enforcement proceeding against an institution<sup>7</sup>
- any reports or other sources of information on institution performance or internal matters created by the institution that do not contain information prohibited from release by law or regulation

and asset quality. CAMEO ratings are assigned to Edge corporations and the overseas branches and subsidiaries of U.S. banks. The CAMEO ratings components are capital, asset quality, management, earnings, and operations and internal controls.

7. Information on enforcement actions taken by the Federal Reserve may be found at <https://www.federalreserve.gov/apps/enforcementactions/search.aspx>.

Information on enforcement actions taken by other federal agencies, such as the Securities and Exchange Commission, the Financial Crimes Enforcement Network, and the Department of Justice, as well as foreign authorities, may also be publicly available.

1065.0.3 CONFIDENTIALITY  
PROVISIONS IN THIRD-PARTY  
AGREEMENTS

Under the Federal Reserve's statutory examination authority, examiners may review all books and records maintained on the premises of a financial institution that is subject to Federal Reserve supervision. This authority extends to any and all documents on the premises. In addition, under the Board's Rules Regarding Availability of Information, other than as set forth in the rules, Board-supervised organizations are prohibited from disclosing CSI to third parties without prior written permission of the Board's General Counsel. CSI is defined to include any information related to the examination or inspection of a banking organization, including supervisory ratings.<sup>8</sup> Significantly, Board staff has taken the position that identification of information requested by, or provided to, supervisory staff—including the fact that an inspection has taken or will take place—is related to an inspection and falls within the definition of CSI. Accordingly, it is contrary to Federal Reserve regulation and policy for agreements between a banking organization and its counterparties (for example, mutual funds, hedge funds, and other trading counterparties) or other third parties to contain confidentiality provisions that

1. restrict the banking organization from providing information to Federal Reserve supervisory staff;
2. require or permit, without the prior approval of the Federal Reserve, the banking organization to disclose to a counterparty that any information will be or was provided to Federal Reserve supervisory staff; or
3. require or permit, without the prior approval of the Federal Reserve, the banking organization to inform a counterparty of a current or upcoming Federal Reserve inspection or any nonpublic Federal Reserve supervisory initiative or action.

Banking organizations that have entered into agreements containing such confidentiality provisions are subject to legal risk. (See [SR-07-19](#), "Confidentiality Provisions in Third-Party Agreements," and [SR-97-17](#), "Access to Books and Records of Financial Institutions During Examinations and Inspections.")

8. See 12 CFR 261.2(c)(1)(i).

### 1070.1.1 INTRODUCTION

This section on the communication of supervisory findings is based on the guidance in [SR-13-13/CA-13-10](#), “Supervisory Considerations for the Communication of Supervisory Findings,” which applies to all Federal Reserve-supervised banking organizations. In a supervisory finding, examiners should convey, if evident, both the root cause of the finding and the potential effect of the finding on the organization. Examiners should also consider the “Statement Clarifying the Role of Supervisory Guidance,” for more information on communication of supervisory findings, including the appropriate identification of issues that could have a negative effect on safety and soundness on the financial institution; could cause consumer harm; or could cause violations of laws, regulations, final agency orders, or other legally enforceable conditions.<sup>1</sup>

### 1070.1.2 COMMUNICATION OF SUPERVISORY FINDINGS

Communication of supervisory findings to the organization’s board of directors is an important part of the supervision of a banking organization. While the board itself may not directly undertake the work to remediate supervisory findings as senior management is responsible for the organization’s day-to-day operations, it is nevertheless important that the board be made aware of significant supervisory issues and ultimately be accountable for the safety and soundness and assurance of compliance with applicable laws and regulations of the organization.

Depending upon the size and complexity of the organization, supervisory findings are communicated in writing through formal examination or inspection reports, reports summarizing the results of targeted reviews, a roll-up of those reviews into a comprehensive report, any other supervisory communication, or some combination thereof. These written communications (referred to collectively as “reports” in this section) are generally directed to the board of directors, or an executive-level committee of the board as appropriate.<sup>2</sup> In turn, the board of

directors (or executive-level committee of the board) typically will direct the organization’s management to take corrective action and will provide management with appropriate oversight, including approvals of proposed management actions as necessary.

To be effective, the communication of supervisory findings must be (1) written in clear and concise language, (2) prioritized based upon degree of importance, and (3) focused on any significant matters that require attention. Reserve Banks must formally communicate matters requiring immediate attention (MRIAs) and matters requiring attention (MRAs) resulting from any supervisory activity to the organization in these written reports. In order to promote an understanding of these terms, examiners should include definitions of MRIAs and MRAs in all supervisory documents communicating supervisory findings.<sup>3</sup> When included in a safety-and-soundness examination or inspection report, MRIAs and MRAs should be listed in the “Matters Requiring Attention” section. In the case of findings from consumer compliance examinations, MRIAs and MRAs should be reflected in the “Executive Summary and Examination Ratings” section of the consumer affairs report of examination. Only outstanding MRIAs and MRAs are required to be discussed in the report; however, examiners have discretion to discuss closed MRIAs and MRAs in the report if such discussion would be meaningful.

For large banking organizations, an annual roll-up report summarizes the significant findings, based on outstanding MRIAs or MRAs, included in the reports of targeted reviews or other supervisory activities conducted during the supervisory cycle. These findings may be grouped by major supervisory issues, rating components, risks, or themes. This information should enable the banking organization’s board of directors and any executive-level committee of the board to understand the substance and status of outstanding MRIAs or MRAs and focus their attention on the most critical and time-sensitive issues.

3. In a safety-and-soundness report, these definitions could be included on the “Scope” page, in an appendix, or as a footnote on the “Matters Requiring Attention” section. In a consumer compliance report, these definitions could be included on the “Executive Summary and Examination Ratings” section.

1. 12 CFR part 262, appendix A and 86 Fed. Reg. 18,179 (April 8, 2021).

2. An executive-level committee of the board (such as, the audit committee or risk committee) typically meets regularly, keeps minutes of those meetings, and is accountable to and routinely reports to the board of directors.

Communications to banking organizations concerning safety-and-soundness or consumer compliance MRAs must specify a timeframe within which the banking organization must complete the corrective actions. In certain circumstances, examiners may require the banking organization to submit an action plan that identifies remedial actions to be completed within specified timeframes. Action plans with intermediate- and long-term timeframes that span more than one supervisory or examination cycle with regard to safety-and-soundness matters, or a 12-month period with regard to consumer compliance issues, should include interim progress targets. Both safety-and-soundness and consumer protection or compliance considerations will remain a priority in determining whether the organization's timeframes to correct the matter are reasonable.

1070.1.2.1 Matters Requiring Immediate Attention

MRIs arising from an examination, inspection, or any other supervisory activity are matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately and include (1) matters that have the potential to pose significant risk to the safety and soundness of the banking organization; (2) matters that represent significant non-compliance with applicable laws or regulations; (3) repeat criticisms that have escalated in importance due to insufficient attention or inaction by the banking organization; and (4) in the case of consumer compliance examinations, matters that have the potential to cause significant consumer harm. An MRI will remain an open issue until resolution and examiners confirm the banking organization's corrective actions.

*Required language.* Federal Reserve examiners are expected to use the following standardized language to communicate MRIs to the board of directors (or executive-level committee of the board):

“The board of directors (or executive-level committee of the board), or banking organization is *required to immediately...*”

*Timeframe.* The expected timeframe for a banking organization to address MRIs is generally short, and may be “immediate,” in the case of

heightened safety-and-soundness or consumer compliance risk. For MRIs that are necessary to preserve or restore the viability of a banking organization, the timeframe should take into account any potential losses to the Federal Deposit Insurance Corporation's Deposit Insurance Fund, including the possibility that a delay in action will increase the potential for loss or the cost of resolution.

*Organization response.* Following its review of MRIs discussed in the report, the banking organization's board of directors is required to respond to the Reserve Bank in writing regarding corrective action taken or planned along with a commitment to corresponding timeframes.

*Supervisory follow-up.* The Reserve Bank must follow up on MRIs to assess progress and verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe specified for the action being required, and should be appropriate for the severity of the matter requiring the corrective action. The means of follow-up may vary depending upon the nature and severity of the matter requiring the action. Follow-up may take the form of a subsequent examination, a targeted review, or any other supervisory activity deemed suitable for evaluating the issue at hand.

In some cases, when follow-up indicates the organization's corrective action has not been satisfactory, the initiation of additional formal or informal investigation or enforcement action may be necessary. In such cases, examiners should consult with enforcement staff.<sup>4</sup> In all instances, examiners are expected to exercise judgment as to the supervisory activities best suited for evaluating a particular issue. Once follow-up is completed, examiners are expected to clearly and fully document the rationale for their decision to close any issue. Examiners are also expected to communicate in writing the results of their work and findings to the banking organization.

1070.1.2.2 Matters Requiring Attention

MRAs constitute matters that are important and that the Federal Reserve is expecting a banking organization to address over a reasonable period

4. Such consultation should be made in accordance with existing guidance to Reserve Bank supervisory staff on the processing of enforcement actions, which provides that recommendations concerning formal enforcement actions should be submitted to the Board's Legal Division.

of time but when the timing need not be “immediate.” While issues giving rise to MRAs must be addressed to ensure the banking organization operates in a safe and sound and compliant manner, the threat to safety and soundness is less immediate than with issues giving rise to MRIAs. Likewise, consumer compliance concerns that require less immediate resolution should be communicated as an MRA. An MRA typically will remain an open issue until resolution and confirmation by examiners that the banking organization has taken corrective action. If a banking organization does not adequately address an MRA in a timely manner, examiners may elevate an MRA to an MRIA. Similarly, a change in circumstances, environment, or strategy can also lead to an MRA becoming an MRIA. The key distinction between MRIAs and MRAs is the nature and severity of matters requiring corrective action as well as the immediacy with which the banking organization must begin and complete corrective actions.

*Required language.* Federal Reserve examiners are expected to use the following standardized language to communicate MRAs to the board of directors (or executive-level committee of the board):

“The board of directors (or executive-level committee of the board), or banking organization *is required to...*”

*Timeframe.* Communications to banking organizations about MRAs must specify a timeframe within which the corrective action is expected to be completed. The timeframe, at least initially, may require estimation because the banking organization may first need to complete preliminary planning to establish the timeframe for initiating and completing the corrective action. The timeframes for MRAs are likely to become more precise over time as planning evolves and circumstances make the completion of the MRAs more urgent. Timeframes that span more than one examination cycle for safety-and-soundness issues or that exceed 12 months for consumer compliance issues should include appropriate interim progress reports.

*Organization response.* Following its review of the report, the banking organization’s board of directors is required to provide a written response to the Reserve Bank regarding its plan, progress, and resolution of the MRA.

*Supervisory follow-up.* The Reserve Bank must follow-up on MRAs to assess progress and

verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe during which actions are to be completed. For intermediate- or long-term corrective actions for MRAs, Reserve Bank follow-up may consist of assessing the organization’s progress to address the MRAs, whether satisfactory or unsatisfactory, and noting whether the initial estimated timeframe continues to be reasonable or warrants adjustment.

The means of supervisory follow-up may vary based upon the nature and severity of the matter for which corrective action is expected. Follow-up may take the form of a subsequent examination, targeted review, continuous monitoring, reliance on validation work conducted by internal audit function, reliance on the results of examinations conducted by other supervisors, or any other supervisory activity deemed suitable for evaluating the issue at hand.<sup>5</sup>

In some cases, when follow-up indicates the organization’s corrective action has not been satisfactory, the initiation of additional formal or informal investigation or enforcement action may be necessary. In all instances, examiners are expected to exercise judgment regarding the supervisory activities best suited for evaluating a particular issue. Once follow-up is complete, examiners are expected to clearly and fully document the rationale for their decision to close any issue. Examiners also are expected to communicate in writing the results of their work and findings to the organization.

### 1070.1.2.3 Supervisory Considerations

The volume of MRIAs and MRAs should be one of the many considerations in assigning a supervisory rating to a banking organization. The presence of a large number of MRIAs or MRAs may indicate that additional formal or informal investigation may be necessary or that the initiation of a formal or informal enforcement action may be warranted.

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5. Examiners may choose to rely on the work of internal audit when internal audit’s overall function and related processes are effective, as discussed in [SR-13-1/CA-13-1](#), “Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing.” (See this manual’s section entitled “Internal Control and Audit Function, Oversight, and Outsourcing.”) When relying on internal audit to follow up on MRAs, examiners are expected to review the relevant workpapers and, when necessary, meet with internal audit staff who documented the resolution of the issue.

Irrespective of the number of MRIs or MRAs, in some cases, additional formal or informal investigation may be necessary or the initiation of a formal or informal enforcement action may be warranted based on the severity of the issues, the repeat nature of issues, lack of responsiveness of management, violations of law, insider abuse, fraud, or other material deficiency. In any of these cases, examiners should consult with the Board’s enforcement staff.

1070.1.3 FACTORS IN ESCALATING ISSUES INTO ENFORCEMENT ACTIONS

The volume of open MRIs and MRAs and the materiality of the issues therein to the safety and soundness of the banking organization are important overarching considerations in determining whether examiners need to consult with the Board’s enforcement staff in escalating issues into enforcement actions.<sup>6</sup> In addition to the guidance presented in SR-13-13/CA-13-10, examiners should consider the following key factors in determining whether to recommend additional formal or informal investigation or enforcement action:

- the organization’s supervisory ratings and financial condition;<sup>7</sup>

- whether the issues involve unsafe or unsound practices, violations of laws, noncompliance with regulations, insider abuse, fraud, or other material deficiencies;<sup>8</sup>
- the severity or repetitive or intentional nature of the issues;
- management’s willingness and ability to correct the issues;
- management’s history of instituting timely remedial or corrective actions;
- whether management already initiated corrective action or established procedures to prevent future deficiencies;
- whether criminal or other regulatory authorities are taking a formal enforcement or prosecutorial action against the same institution;
- the organization’s history of violations of laws, noncompliance with regulations and unsafe and unsound unsatisfactory practices; and
- any other circumstances that warrant use of an enforcement action.

This manual’s section, “Formal Corrective Actions,” provides more information on formal supervisory actions, which regulators issue to correct practices that the regulators believe to be unlawful, unsafe, or unsound. See also the *Commercial Bank Examination Manual’s* section entitled, “Formal and Informal Supervisory Actions,” for more information.

6. Issues are considered closed if the banking organization implements and examiners verify and validate the effectiveness of the corrective action, or if the organization’s practices are no longer a concern because of a change in the organization’s circumstances.

7. See SR-19-3/CA-19-2, “Large Financial Institution (LFI) Rating System;” and SR-19-4/CA 19-3, “Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than \$100 billion.”

8. See 12 USC 1818(b)(1).

# Considerations in Assigning and Revising Supervisory Ratings

## Section 1072.0

### 1072.0.1 GENERAL CONSIDERATIONS IN REVISING SUPERVISORY RATINGS

Supervisory ratings can affect an institution's risk-based deposit insurance premium; statutory and regulatory requirements, including applications of the Federal Deposit Insurance Act; supervisory reporting and inspection or examination requirements; and other factors. Given these implications, supervisory ratings should reflect an institution's current financial condition and risk profile. As such, Federal Reserve examiners should revise supervisory ratings whenever there is strong evidence that the financial condition or risk profile of an institution has significantly changed.<sup>1</sup>

Supervisory ratings may be revised as a result of on-site or off-site supervisory activities. For example, a significant change in an institution's financial condition may be evident from some combination of the following: off-site information or monitoring, reports of examinations conducted by another agency, meetings or other communications with management of the institution, published financial reports or press releases, an institution's status reports in connection with an enforcement action, and information generated by ongoing surveillance activities.

When examiners change a component of one of the supervisory rating systems, they should consider whether other applicable ratings should change, based on information available at that time. The factors contributing to a change in the rating of a component rating may affect one or more of the other ratings in the rating system, such as the composite rating (if applicable).<sup>2</sup> Further, a rating change at the holding company

may precipitate a rating change at the subsidiary depository institution or vice versa.

Any change to a component or composite rating and the rationale for that change must be communicated by Federal Reserve supervisory staff in writing via a supervisory letter or report to the board of directors of the affected institution (or to the senior U.S. management official in the case of a U.S. branch, agency, office, or nonbank subsidiary of a foreign bank) and to the appropriate state and federal supervisory agencies. Federal Reserve Bank examiners should follow internal procedures for reviewing, vetting, and approving interim rating changes with Reserve Bank management and Federal Reserve Board staff, as well as communicating ratings changes to supervised institutions.

### 1072.0.2 UPGRADES OF SUPERVISORY RATINGS AT COMMUNITY BANKING ORGANIZATIONS

In 2012, the Federal Reserve issued guidance instructing examiners to use balanced judgment and consider progress by institutions in addressing supervisory issues and in restoring an institution to satisfactory condition when assigning ratings. See [SR-12-4](#), "Upgrades of Supervisory Ratings for Banking Organizations with \$10 Billion or Less in Total Consolidated Assets." Examiners should upgrade an institution's supervisory rating when there is a demonstrated improvement in the institution's financial condition and risk-management practices, and where improvement is likely to continue. In particular, the Federal Reserve supervisory staff should evaluate the strength of an institution's core financial components, overall risk management, and board of directors' oversight in assessing whether an upgrade is warranted.

Additional specific considerations include the extent to which

- the level of capital and capital planning process are appropriate relative to risk characteristics;
- core earnings have improved, and this trend is demonstrably sustainable;
- asset quality is improving, as evidenced by a material decline of adversely classified and

1. For more information, see [SR-99-17](#), "Supervisory Ratings for State Member Banks, Bank Holding Companies and Foreign Banking Organizations, and Related Requirements for the National Examination Data System." The guidance in [SR-99-17](#) and this manual section generally applies to the supervisory rating systems for bank holding companies and savings and loan holding companies; state member banks; U.S. branches and agencies of foreign banking organizations; and Edge and agreement corporations, overseas subsidiaries of U.S. banks, and U.S. nonbank subsidiaries of foreign banking organizations.

2. For more information on the scope and applicability of the holding company rating systems see [SR-13-21](#), "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of \$10 Billion or Less," [SR-19-3/CA-19-2](#), "Large Financial Institution (LFI) Rating System," and attachment 1 to [SR-19-4/CA-19-3](#), "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than \$100 billion."

nonperforming assets, and this trend is expected to continue;

- liquidity and interest rate risk positions generally are managed prudently and, in a manner, consistent with applicable supervisory guidance;
- management's projections and assumptions related to core financial factors referred to above are reasonable and subject to regular board review and oversight;
- risk-management capabilities have improved to address principal weaknesses that contributed to prior ratings, and policies and practices have been implemented that focus on sustainability commensurate with the bank's risk profile; and
- the board provides strategic review and oversight of the institution's core financial factors and risk management and actively engages in the process of correcting deficiencies.

The Federal Reserve supervisory staff also should consider whether the institution has made demonstrable and sustained improvement in particular areas relevant to the institution's operation and financial condition as noted in reports of examination and condition.

### 1072.0.3 LARGE FINANCIAL INSTITUTIONS AND THE LFI RATING SYSTEM

While smaller banks and holding companies generally are examined at a specific point in time, larger holding companies are subject to continuous monitoring and ongoing supervision, which includes several supervisory events or assessments over the course of the supervisory cycle. Federal Reserve policy guidelines state that Federal Reserve supervisory staff should assign larger holding companies the appropriate holding company ratings on an annual basis and more frequently as warranted. (See [SR-19-4/CA-19-3](#).) The Federal Reserve has internal

processes and procedures for initiating and appropriately vetting ratings changes. This process involves a coordinated vetting of assigning and revising ratings for large holding companies subject to the LFI rating system.

For larger holding companies, rating changes typically are precipitated by the completion of significant supervisory assessments completed throughout the supervisory cycle. For instance, horizontal supervisory events and supervisory events assessing a firm's ability to address material findings identified in previous supervisory events are common instances when Federal Reserve examiners should consider the need to adjust an institution's ratings. In all cases, examiners should revise the supervisory ratings when an institution's financial or operational strength and resilience change and no longer meet the criteria for the existing rating.

The importance of examiners providing timely and accurate assessments of a larger holding company's financial and operational condition is reflected in the LFI rating system. As described in this manual's section entitled, "Large Financial Institution Rating System," each LFI component rating is assigned along a four-level scale. A firm is rated "Conditionally Meets Expectations" when it has certain material financial or operational weaknesses in its practices or capabilities, which may place the institution's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business. Firms assigned a "Conditionally Meets Expectations" rating should not be rated as such for a prolonged period. The LFI ratings framework does not have a fixed timeline for how long a firm can be rated "Conditionally Meets Expectations." Instead, the LFI ratings framework reflects an understanding that timelines depend on the particular issue(s), noting that the Federal Reserve will work with the institution to develop appropriate timeframes for resolving the supervisory issues leading to the "Conditionally Meets Expectations" rating.

### 1075.0.1 STATUTORY TOOLS FOR FORMAL SUPERVISORY ACTION

The Federal Reserve supervises the following entities and has the statutory authority to take formal enforcement actions against them:

- state member banks
- bank holding companies (BHCs)
- savings and loan holding companies (SLHCs)
- nonbank subsidiaries of BHCs and of SLHCs
- Edge Act and agreement corporations
- branches and agencies of foreign banking organizations operating in the United States and their parent banks
- systemically important nonbank financial companies designated by the Financial Stability Oversight Council (FSOC) for supervision by the Federal Reserve
- officers, directors, employees, and certain other categories of individuals or entities associated with the above banks, companies, and organizations (referred to as “institution-affiliated parties”)

The initial consideration and determination of whether formal action is required usually results from an examination or inspection. As such, Federal Reserve supervisory staff must include comments and conclusions in an examination report or other supervisory communications that are well supported, factually accurate, consistent, and void of editorial or inflammatory statements.

Statutory tools are available to the Federal Reserve Board if formal enforcement action is warranted against a BHC or SLHC (collectively, “holding company”), nonbank subsidiaries, or institution-affiliated parties. The primary objectives of formal actions include

- correcting practices that the regulators believe to be unlawful, unsafe, or unsound;<sup>1</sup>
- ensuring that appropriate corrective action programs are developed and used by financial institutions subject to formal actions;
- minimizing losses to financial institutions and the Federal Deposit Insurance Fund;
- ensuring that Federal Reserve requirements are complied with to the fullest extent possible by financial institutions and individuals; and
- ensuring that institution-affiliated parties who engage in an unsafe or unsound practice or

violate the law are permanently barred from the banking industry, fined, or both, for their malfeasance.

In addition to an institution’s supervisory ratings, compliance with statutes and regulations, and financial and managerial condition, Federal Reserve supervisory and legal staff consider numerous factors in determining whether to recommend additional formal or informal investigation or enforcement action. See the “Communication of Supervisory Findings” section in this manual to review factors in escalating issues into enforcement actions.

The Board does not issue an enforcement action on the basis of a “violation” of or “non-compliance” with supervisory guidance. This includes various types of Board or interagency supervisory guidance, interagency statements, advisories, letters, policy statements, questions and answers, and frequently asked questions. While supervisory guidance provides examples of practices that the Board generally considers consistent with safety-and-soundness standards or other applicable laws and regulations, supervisory guidance does not have the force and effect of law. See 12 C.F.R. part 262, appendix A, “Statement Clarifying the Role of Supervisory Guidance.”

This section discusses the following topics:

- Board jurisdiction under the law
- actions or practices that may trigger the statutory remedies
- Board staff procedures
- the elements of a corrective order
- temporary orders
- written agreements
- suspensions and removals
- enforcement of orders
- civil money penalties
- indemnification payments and golden parachutes
- termination of certain nonbank subsidiary activities or ownership
- coordination of formal enforcement actions among federal banking agencies

1. For more information on informal supervisory actions, see the *Commercial Bank Examination Manual* section (1050.1) entitled, “Formal and Informal Supervisory Actions.”

1075.0.2 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, (2) a nonbank subsidiary of a BHC, and (3) any institution-affiliated party.<sup>2</sup> 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. Further, institution-affiliated parties generally include

- shareholders;
- consultants;
- joint venture partners or any other person who participates in the conduct of the affairs of a BHC or nonbank subsidiary; and
- independent contractors, including attorneys, appraisers, and accountants who knowingly or recklessly participate 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.<sup>3</sup>

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.

1075.0.2.1 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 unsafe or unsound practices or legal violations and (2) take affirmative action to correct the violations or practices. Affirmative actions are actions necessary to restore the BHC to a safe and sound condition, and include
- improving the BHC’s consolidated capital by restricting dividends and new debt;
  - conserving the BHC’s assets so it can serve as a source of strength to the bank;
  - employing qualified officers or employees; or
  - taking 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. If the BHC or individual voluntarily agrees 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 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 starts a formal process that includes the convening of a public administrative hearing to be conducted before an administrative law judge.<sup>4</sup> After the hearing, the judge makes a recommended decision to the

2. The Board’s authority under 12 U.S.C. 1818 also extends to SLHCs, their nonbank subsidiaries, and their institution-affiliated parties.

3. 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)).

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

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, the Board 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.

### 1075.0.2.2 Temporary Cease and Desist Orders

The Board may, in conjunction with issuing a notice of charges, issue a temporary cease and desist order against a BHC or an institution-affiliated party to effect immediate correction (pursuant to 12 U.S.C. 1818(c)). The Board may issue a temporary cease and desist order to a BHC when the violation or unsafe or unsound practice described in the notice of charges, or the continuation of the violation or practice is likely to

- cause insolvency of a BHC or its subsidiary bank,
- weaken the condition of the BHC,
- cause a significant dissipation in earnings, or
- prejudice the interests of the subsidiary bank's depositors before the completion of the proceedings resulting from the notice of charges.

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 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.

### 1075.0.2.3 Written Agreements

When circumstances warrant a less severe public action than a cease and desist order, it may be appropriate to execute a written agreement with a supervised institution. 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 Supervision and Regulation. After approval by the General Counsel, the Reserve Bank may enter into the written agreement under delegated authority (12 C.F.R. 265.11(a)(15)).

### 1075.0.2.4 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, BHC or SLHC, and non-bank 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.

In addition to this legal authority, the statute separately 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.<sup>5</sup>

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.

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 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 has entered into a pretrial diversion or similar program for, a crime involving personal dishonesty or breach of trust if his or her continued service would threaten the interests of the institution's depositors or impair public confidence in the institution. The Board is required to issue such an order against any institution-affiliated party who has been con-

victed of, or pleaded to, a violation of the money-laundering statutes.

Furthermore, section 19 of the Federal Deposit Insurance Act (12 U.S.C. 1829) prohibits any individual who has been convicted of, or has entered into a pretrial diversion or similar program for, 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 such an individual from holding any of the above-listed positions at a holding company or an Edge Act or agreement corporation without the Board's prior approval. The penalty for a knowing violation of this law is a potential fine 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.

1075.0.2.5 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.

1075.0.2.6 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

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

“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.

### 1075.0.2.7 Civil Money Penalties

The Board is authorized to address misconduct by any institution or institution-affiliated party through the imposition of civil money penalties under a variety of statutes, including most commonly 12 U.S.C. 1818(i)(2). The statutory maximums are adjusted annually for inflation; current maximums may be found at 12 C.F.R. 263.65. Under 12 U.S.C. 1818(i)(2), the Board may assess a first-tier civil money penalty 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 second-tier civil money penalty 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 third-tier civil money penalty 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 under the three-tier penalty structure of 12 U.S.C. 1847(d) or, for SLHCs, 12 U.S.C. 1467a(r). 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 first-tier civil money penalty. The financial institution has the burden of proving that the error was inadvertent under these circumstances. If the

error was not inadvertent, a second-tier penalty 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 third-tier penalty 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 under 12 U.S.C. 1847(d).

### 1075.0.2.8 Administration of Formal Actions

#### *1075.0.2.8.1 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.<sup>6</sup> 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.

#### *1075.0.2.8.2 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. Ap-

6. For enforcement actions against an entity supervised by the Federal Reserve, see the [Board’s public website](#).

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.

1075.0.2.8.3 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, as well as the authority to administer oaths or take depositions in connection with an examination or inspection.

1075.0.3 PROHIBITED INDEMNIFICATION PAYMENTS AND GOLDEN PARACHUTE PAYMENTS

Prohibited indemnification payments and golden parachute payments are governed by section 18(k) of the FDI Act (12 U.S.C. 1828(k)) and the FDIC’s accompanying regulations at 12 C.F.R. part 359.

1075.0.3.1 Prohibited Indemnification Payments

Holding companies or insured depository institutions 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 holding companies or insured depository institutions may have broadly worded indemnification provisions, or the holding company or institution may have entered into separate indemnification agreements with its 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 and the accompanying Federal Deposit Insurance Corporation (FDIC) regulations.<sup>7</sup> The

law and regulations apply to indemnification agreements and payments made by a holding company or insured depository institution to any institution-affiliated party, regardless of the holding company’s or institution’s financial condition. 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 holding company or insured depository institution to an institution-affiliated party to pay or reimburse such person for any liability or legal expense incurred in any federal banking agency 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 and desist from or take any affirmative action, including making restitution, with respect to the holding company or depository institution.<sup>8</sup>

The FDIC’s regulations provide criteria for making permissible indemnification payments. A holding company or insured depository institution 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 after due investigation and consideration that the institution-affiliated party acted in good faith and the best interests of the institution;
- ii. the board of directors determines in writing after due investigation and consideration 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 the portion of the advanced indemnification payments which subsequently become prohibited indemnification payments.<sup>9</sup>

The statute and FDIC regulations reinforce the Federal Reserve’s long-standing policy that an institution-affiliated party who engages in misconduct should not be insulated from the

7. See 12 U.S.C. 1828(k). The prohibition begins when a proceeding is instituted, which is when a notice of charges is issued.

8. 12 C.F.R. 359.1(l).  
9. 12 C.F.R. 359.5(a).

consequences of their misconduct. From a safety-and-soundness perspective, a holding company 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 holding company's policy of compliance with applicable laws, especially when the individual's misconduct has already harmed the holding company.

Holding companies should review their by-laws 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 holding company 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, Federal Reserve supervisory staff and examiners will review identified agreements having indemnification-related issues for compliance with federal laws and regulations.<sup>10</sup>

### 1075.0.3.2 Golden Parachute Payments

FDIC regulations prohibit holding companies and their insured depository institution subsidiaries from making golden parachute payments except in certain circumstances. As described in 12 C.F.R. 359.0(b), the limitations on golden parachute payments apply to

- troubled insured depository institutions which seek to enter into contracts to pay or to make golden parachute payments to their institution-affiliated parties;<sup>11</sup>

- depository institution holding companies which are troubled and seek to enter into contracts to pay or to make golden parachute payments to their institution-affiliated parties; and
- healthy holding companies which seek to enter into contracts to pay or to make golden parachute payments to institution-affiliated parties of a troubled insured depository institution subsidiary.

The purposes of the law and regulations include safeguarding the assets of financial institutions and limiting rewards to institution-affiliated parties who may have contributed to the institution's troubled condition. (See [SR-03-6](#), "Guidance Regarding Restrictions on Institutions in Troubled Condition.")

A golden parachute payment is any payment (or agreement to make any payment) in the nature of compensation for the benefit of any current or former institution-affiliated party that meets three criteria.

1. The payment or agreement must be contingent on, or by its terms payable on or after, the termination of the institution-affiliated party's primary employment or affiliation.
2. The agreement is made, or the payment is to be made on or after, or made in contemplation of, among other things, a determination that the holding company or its insured depository institution subsidiary is in a troubled condition.
3. The payment is payable to an institution-affiliated party who is terminated while a holding company or its insured depository institution subsidiary meets any of the troubled condition criteria in the golden parachute regulations.

The definition of a golden parachute payment also covers a payment made by a holding company that is not in a troubled condition to an institution-affiliated party of an insured depository institution subsidiary that is in a troubled

10. For additional information, consult [SR-02-17](#), "Guidance Regarding Indemnification Agreements and Payments." The guidance in [SR-02-17](#) and [SR-03-6](#) also apply to SLHCs. See [SR-14-9](#), "Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program." For additional considerations for institutions in choosing indemnification insurance policies, see [SR-19-12](#), "Statement Regarding Insurance Policies for Directors and Officers."

11. See 12 C.F.R. 359.1(f)(1)(ii). The Board's Regulation Y (12 C.F.R. 225.71) states that "troubled condition" for a regulated institution means an institution that (1) has a composite rating, as determined in its most recent report of examination or inspection, of 4 or 5 under the CAMELS rating system or the Federal Reserve Bank Holding Company rating system; (2) is subject to a cease-and-desist order or formal written agreement that requires action to improve the financial condition of the institution, unless otherwise informed in writing by the Board or Reserve Bank; or (3) is informed in writing by the Board or Reserve Bank that it is in troubled condition for purposes of the requirements of subpart H of Regulation Y on the basis of the institution's most recent report of condition or report of examination or inspection, or other information available to the Board or Reserve

Bank. Note that under the Federal Reserve's holding company rating system for large financial institutions, there is no presumption that a firm rated "Deficient-1" would be deemed to be in troubled condition. Whether a firm rated "Deficient-1" receives a troubled condition designation will be determined by the facts and circumstances of the situation. However, firms rated "Deficient-1" due to financial weaknesses in either capital or liquidity would be more likely to be deemed in troubled condition than firms rated "Deficient-1" due solely to issues of governance or controls. See 83 Fed. Reg. 58,724 (November 21, 2018) and 84 Fed. Reg. 4309 (February 15, 2019) for more information.

condition, if the other criteria in the definition are met. This circumstance may arise when a holding company, as part of an agreement to acquire a troubled holding company, bank, or savings association, proposes to make payments to the troubled institution’s institution-affiliated parties that are conditioned on their termination of employment.<sup>12</sup>

Holding companies or insured depository institutions may request permission from the appropriate federal banking agency to make or enter into an agreement to make a golden parachute payment by filing an application in accordance with FDIC filing instructions at 12 C.F.R. 303.244. The appropriate federal banking agency may approve the application under one of the exceptions in 12 C.F.R. 359.4(a) (1)-(3). In determining the permissibility of the payment, the Federal Reserve may consider whether, and to what degree, the individual was in a position of managerial or fiduciary responsibility, the length of time the individual was affiliated with the institution and 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. Generally, FDIC approval will also be required before a payment is permissible.

A holding company 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 Reserve Bank should forward the golden parachute application to appropriate Board staff for a final determination on the permissibility of the request. Golden parachute payments or agreements may be approved by the Board’s Director of the Division of Supervision and Regulation in conjunction with the General Counsel. Denials are not delegated by the Board of Governors to Board or Reserve Bank staff.

If a holding company or state member bank makes or enters into an agreement to make a golden parachute payment without prior regula-

tory approval, 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 holding company 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 Supervision and Regulation and Legal Division should be notified and consulted on the golden parachute-related issues.

1075.0.4 ENFORCEMENT ACTIONS FOR BANK SECRECY ACT/ANTI MONEY LAUNDERING COMPLIANCE PROGRAM FAILURES

In 2020, the federal banking agencies (FBAs) issued a joint statement updating their existing enforcement guidance to enhance transparency regarding how they evaluate enforcement actions that are required by statute when financial institutions fail to meet Bank Secrecy Act/anti-money laundering (BSA/AML) obligations.<sup>13</sup> The statement addresses how the agencies evaluate violations of individual components (known as pillars) of the BSA/AML compliance program. The statement also clarifies that isolated or technical violations or deficiencies are generally not considered the kinds of problems that would result in a mandatory enforcement action. The statement promotes a consistent approach to the application of section 8(s) of the FDI Act. See [SR-20-19](#), “Joint Statement on Enforcement of Bank Secrecy Act/Anti-Money Laundering Requirements.”

1075.0.5 COORDINATION OF FORMAL ENFORCEMENT ACTIONS AMONG FEDERAL BANKING AGENCIES

When an FBA determines to take a formal enforcement action against any federally insured depository institution, depository institution holding company, non-bank affiliate, or institution-affiliated party, the agencies evaluate whether

12. FDIC 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 FDIC 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 regulations.

13. FBA refers to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency.

the enforcement action involves the interests of another FBA. Examples of such interests include unsafe or unsound practices or significant violations of law by an insured depository institution, non-bank affiliate, or depository institution holding company or misconduct by an institution-affiliated party that may have significant connections with an institution regulated by another FBA. If it is determined that one or more other FBAs have an interest in the enforcement action, the FBA proposing the enforcement action notifies the other FBA(s). For more information, see [SR-18-4/CA-18-5](#), “Policy Statement on Inter-agency Notification of Formal Enforcement Actions,” and 83 Fed. Reg. 27,371 (June 12, 2018).

#### 1075.0.6 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 must provide 30 days’ written notice to the Board before appointing any new director or senior executive officer,<sup>14</sup> or changing the responsibilities of any senior executive officer so that the officer would assume a different senior officer position if

- the regulated institution is in troubled condition;
- the regulated institution does not meet minimum capital requirements applicable to the institution as determined on the basis of the institution’s most recent report of condition or report of examination or inspection; or
- the Board determines, in connection with its review of a capital restoration plan required under section 38 of the Federal Deposit Insurance Act or subpart D of the Board’s Regulation H (prompt corrective action requirements), or otherwise, that such notice is appropriate.

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-day 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.

#### 1075.0.7 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 rules (12 C.F.R. part 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. See [SR-94-3](#), “Supervisory Guidance on the Implementation of Section 112 of the FDIC Improvement Act.”

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. See [SR-13-11](#), “Filing Procedures for Annual Independent Audits and Reports Required Under Federal Deposit Insurance Corporation (FDIC) Rules,” for more information.

Section 36 and the rules enacted pursuant thereto set forth the practices and procedures to remove, suspend, or debar, for good cause, an accountant or firm from performing audit and testation services for an insured state member bank, or BHC that obtains audit services for an

14. 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.

insured subsidiary bank.<sup>15</sup> 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.

15. 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.

The Federal Reserve's Holding Company (HC) Surveillance Program covers top-tier bank and savings and loan holding companies. It deploys risk identification algorithms and other surveillance products to process financial and economic data and generate forward-looking, actionable intelligence on HCs. Results are used to assess exposures, outlooks, and possible compliance shortcomings, with the goal of calibrating supervisory resources to risk. (Refer to [SR-15-16](#) and its attachment.)

The surveillance program's objectives cover these areas: (1) HC monitoring, (2) industry analysis, and (3) metric distribution. HC monitoring consists of forward-looking metrics targeting high-risk HCs and those with emerging financial difficulties for enhanced supervisory attention, while identifying low-risk HCs for more streamlined approaches. The metrics also detect possible regulatory violations or departures from supervisory guidance and feed into financial reports on individual HCs. In industry analysis, aggregate data views and accompanying financial analyses inform Federal Reserve leaders of broad financial institution conditions and trends. In metric distribution, web applications deliver surveillance results to examiners and other supervisory staff.

As fully integrated into the supervisory process, the HC Surveillance Program involves three distinct phases. First, data are processed by the risk identification algorithms, ranging from simple rules to financial models, machine learning, and signal processing. The algorithmic system's main components are the Outlier List, Watch List, HC Monitoring Screen, and Intercompany Transactions Exception List, all described below. When the algorithms detect departures from expected patterns involving HCs, the results are transmitted via Performance Report Information and Surveillance Monitoring (PRISM), a web application available to Federal Reserve examiners and other supervisory staff for interactive data analysis.

The second phase begins as supervisory staff use additional surveillance products to confirm the initial impressions presented by first-phase surveillance results. Key examples of these additional products are the Bank Holding Company Performance Report (BHCPR), a quarterly financial report on individual HCs, described below, and the Focus Report, a web application available to Federal Reserve examiners and other supervisory staff for interactive risk assessment. In addition, aggregate data views and reports of financial condition at the supervisory portfolio

and industry levels can help place a particular HC's status in context.

The third phase involves the development of supervisory responses to the information generated in the first two. A primary goal is to focus supervisory resources on excessive risk-taking, the risk of emerging financial difficulties, and possible regulatory compliance shortcomings. When problems are identified, follow-up by examiners promotes correction and resolution. By also identifying low-risk situations, the HC Surveillance Program promotes the application of more streamlined supervisory approaches for such cases.

### 1080.0.1 OUTLIER LIST

An Outlier List highlights HCs with elevated risk-taking and identifies those with expanded or new areas of risk-taking. It is supported by "Outlier Metrics" in the form of algorithms generating risk classifications of low, moderate, or high for individual risk and performance dimensions. The Outlier List includes HCs (FR Y-9C filers only) categorized as high risk within at least one risk or performance dimension. The risk identification algorithms can be based on a broad range of approaches and may evolve over time.

Examiners and other supervisory staff use the Outlier List to monitor a HC's risk-taking and promote adequate risk management and mitigation, with the goal of bolstering HCs' capacity to prevent or buffer financial losses. The Outlier List and its metrics also assist supervisory staff in scoping HC inspections. No regular write-up or documentation requirement is tied to the Outlier List.

### 1080.0.2 WATCH LIST

The Watch List identifies the risk of emerging financial weaknesses among HCs. It includes FR Y-9C filers with composite safety-and-soundness ratings consistent with financial viability, but surveillance grades of 'D' or 'F,' pointing to the possibility of deterioration in inspection findings going forward.

To generate the surveillance grades, the Holding Company Statistical Assessment of Bank Risk (HC-SABR) early-warning model is ap-

plied to financial and supervisory information for each HC filing consolidated financial statements on the FR Y-9C. The HC-SABR rating consists of the composite RFI rating most recently assigned to an HC via the inspection process, coupled with a surveillance letter grade (A, B, C, D, or F) reflecting the HC’s estimated financial condition relative to others in the same rating class.

HC-SABR ratings are designed for use both in monitoring and in determining the scope of an inspection. An accompanying Schedule of Risk Factors (SRF) highlights specific indicators leading the model to flag a particular HC as strong or weak. Through ongoing monitoring, examiners and other supervisory staff review each Watch List HC to assess its financial condition and discern whether substantial deterioration is evident or impending. In such cases, supervisory staff determine whether an inspection or other supervisory initiative might be needed. The Watch List, much like the Outlier List and its metrics, can also be used in scoping HC inspections to target potentially deteriorating situations for the most extensive reviews.

At times, Reserve Bank staff may need to produce supporting documentation to explain the reasons for an HC’s placement on the Watch List and outline the appropriate supervisory response. For HCs other than community banking organizations (CBOs), this type of information is often already contained in quarterly supervisory write-ups outside of the Watch List process. Separate surveillance write-ups are required for CBO HCs on the Watch List when any of the following criteria are met:

- 1. The current HC-SABR rating is worse than the prior quarter; or
- 2. The HC-SABR rating is the same as the prior quarter, but the SRF identifies one or more new contributing factors; or
- 3. The most recent requirement for a write-up occurred four quarters earlier.

The assessments and conclusions comprising a write-up should be brief and supported by analysis. A Watch List write-up should accomplish the following:

- 1. summarize the factors leading to Watch List placement;
- 2. describe any response from the HC to those factors;

- 3. assess the likelihood of further financial deterioration;
- 4. judge whether assigned safety-and-soundness ratings are accurate; and
- 5. determine whether the timing of the next inspection should be accelerated.

Follow-up action associated with newly identified problems must be initiated promptly by Reserve Banks. Follow-up action may include correspondence or meetings with an HC’s management or an on-site inspection. Problem situations should be closely monitored by supervisory staff until they have been corrected or otherwise resolved.

1080.0.3 HC MONITORING SCREEN

The HC Monitoring Screen includes a focus on the parent company and non-depository subsidiaries; addresses issues such as cash flow, leverage, and complexity; identifies risks to depository institution subsidiaries; and helps monitor compliance with regulations and supervisory guidance. It provides examiners and other supervisory staff with additional perspective on the risk position and financial condition of HCs by supplementing the Outlier List and Watch List. The FR Y-9SP is utilized, among other reports, allowing the HC Monitoring Screen to provide a surveillance view of smaller HCs. Those HCs that fail screening criteria are identified, with the criteria themselves updated periodically.

Examiners and other supervisory staff review HC Monitoring Screen results quarterly and follow up with supervisory initiatives when appropriate. Detailed instructions may accompany parts of the screen linked to specific supervisory programs, as for example, the guidance discussed in this manual’s section 1080.1, “Surveillance Program for Small Holding Companies,” and further described in [SR-13-21](#). Unless otherwise instructed as part of a specific supervisory program, staff are not generally required to produce surveillance write-ups or maintain surveillance documentation for HCs on the HC Monitoring Screen.

1080.0.4 INTERCOMPANY TRANSACTIONS EXCEPTION LIST

The Intercompany Transactions Exception List (ITEL) helps track compliance with section 23A of the Federal Reserve Act. The ITEL is a specialized monitoring process utilizing data

from the FR Y-8, together with information from the bank Call report.

For each depository institution possibly exceeding section 23A limits, supervisory staff perform the following: (1) follow up with the HC submitting the FR Y-8 to verify the data are accurate; (2) if an error caused the exception, require an amended report; and (3) if the data are correct, and a depository institution appears to have had covered transactions exceeding section 23A limits, determine the nature and extent of the apparent violation. Reserve Bank staff produce a written review of their findings for each depository institution on the list. The review addresses any apparent violations or reporting errors, along with any corrective action taken.

#### 1080.0.5 THE SURVEILLANCE PROGRAM'S BHC PERFORMANCE REPORT

The HC Surveillance Program generates quarterly financial reports on individual HCs, including a publicly available BHCPR consisting of consolidated and parent-only financial information and peer-group percentiles for HCs filing the FR Y-9C. The information is useful in analyzing HCs on the Outlier List, Watch List, or HC Monitoring Screen. By reviewing the performance reports, examiners and other supervisory staff gain insight into potential HC weaknesses. For example, parent leverage, cash-flow, and coverage ratios can indicate problems at the parent level that could adversely affect depository institution subsidiaries. Information on the parent's income from subsidiaries can potentially indicate problems at non-depository subsidiaries that could negatively affect depository institution subsidiaries.

The financial indicators produced by the BHCPR are leveraged in surveillance models such as HC-SABR and used in the financial analysis of HCs. Some documentation is required to help support the report. Specifically,

the BHCPR's peer group analysis involves the identification of HCs that for a variety of reasons could be considered atypical.

To support this process, Reserve Bank staff annually produce a list of atypical HCs. The list provides the name, location, and ID RSSD of a company; and the reason why the HC is considered atypical. HCs removed from the atypical list relative to the previous year are also identified and discussed.

#### 1080.0.6 ROLE IN INSPECTION PROCESS

HCs identified through the surveillance process as (1) taking on positions or pursuing strategies that could lead to problem situations, (2) having a weak or declining financial condition, or (3) failing to comply with regulations should, in general, be inspected more intensely and frequently than companies without such deficiencies.

Regarding the positions and strategies of HCs, the Outlier List is designed to identify excessive risk-taking, as are parts of the HC Monitoring Screen. Similarly, the Watch List is intended to identify companies having a weak or declining financial condition, as are parts of the HC Monitoring Screen. Also, the HC Monitoring Screen and the ITTEL help detect possible compliance problems among HCs and their subsidiaries.

The full array of risk identification algorithms and products deployed in the HC Surveillance Program can be used in the scheduling and scoping of HC inspections, so as to target, in a timely manner, the riskiest situations for the most extensive reviews, while conserving supervisory resources when risk is low. The examiner-in-charge should exercise prudent supervisory judgment and consider an HC's status on each surveillance list and screen, together with all other available information sources, including the BHCPR and Focus Report, when determining the scope and nature of the inspection work required.

# Surveillance Program for Small Holding Companies

## Section 1080.1

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The surveillance program for holding companies having total consolidated assets of less than \$3 billion is described below. (See [SR-13-21](#), “Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of \$10 Billion or Less.”) The surveillance program is a primary tool for identifying potentially significant changes in the condition of these organizations between reviews and for targeting the work of any onsite reviews. Quarterly surveillance screens identify potential parent-company and nonbank issues that may adversely affect affiliated insured depository institutions. In particular, the screens address parent-company cash flow, intercompany transactions, parent-company leverage, and consolidated capital ratios, where applicable. The surveillance screens are periodically updated to reflect industry trends and issues, as well as changes in regulatory reporting requirements.

Upon receipt and finalization of FR Y-9 data, Board surveillance staff provides each Reserve Bank with the results of the small holding company surveillance screens on a quarterly basis. Reserve Banks should evaluate this information and make a determination as to any appropriate supervisory actions within 45 days of the Board staff notice. In doing so, Reserve Banks should determine whether the screen results reveal that the holding company or its affiliates could pose or exacerbate a material risk to a depository institution subsidiary. If the screen results reveal no basis for a significant concern, no further action is required. Reserve Banks should also review the quarterly FR Y-8 data on transactions between an insured depository institution and its affiliates that are subject to section 23A of the Federal Reserve Act and Regulation W. Reserve Banks should document their FR Y-8 reviews and follow up on any potential violations.

If a Reserve Bank determines that the screen results reveal the potential for material risk to a depository institution, the Reserve Bank should take appropriate follow-up action within 90 days after initially receiving the surveillance results

from Board staff. Follow-up actions may include

- contacting the holding company to obtain more information,
- requesting from the holding company a corrective action plan,
- implementing heightened monitoring procedures, or
- updating the holding company’s complexity designation.

If an onsite review is recommended for a complex holding company, the review should commence within 90 days of the Reserve Bank’s initial notification of the surveillance results from Board staff. The ratings assigned as a result of the onsite review should be promptly entered into the National Examination Data System (NED) and communicated to the company, Board staff, and appropriate state and federal regulatory authorities within 120 days of that notification.

In addition to the above surveillance monitoring screens, Board surveillance staff also provide Reserve Banks with program support screens containing additional information to assist in the supervision of small holding companies. One set of support screens identifies companies that have been designated as noncomplex, but which exhibit characteristics of complex organizations. Reserve Banks are to evaluate any such companies to determine whether their designation as noncomplex should be changed and their supervision program modified accordingly. A second set of support screens monitors compliance of financial holding companies with the capital, managerial, and Community Reinvestment Act standards set forth in the Gramm-Leach-Bliley Act.

Surveillance information is crucial to identifying potential issues between reviews and ensuring that onsite work is risk focused. Accordingly, Reserve Banks should continue taking steps to ensure the accuracy of the regulatory reports that provide the basis for the surveillance program. In particular, System staff is to follow up promptly on any identified inaccuracies.