

## Attachment B.1

### Guidance for the Supervision of the Combined U.S. Operations of Foreign Banking Organizations that are Large Complex Banking Organizations

#### I. Introduction

Consistent with the principle of national treatment,<sup>1</sup> foreign banking organizations (FBOs) are free to structure their activities in the United States in a manner that best suits their business needs and conduct an extensive array of diverse businesses in the United States through a variety of legal entities. This attachment describes the supervisory expectations for Federal Reserve staff in developing an understanding and assessment of the combined U.S. operations of large complex FBOs, i.e., FBOs that are designated as being part of the large complex banking organization (LCBO) portfolio, as discussed in attachment A.1. These expectations cover all activities that are booked in or traded through the U.S. operations of these organizations.<sup>2, 3</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, including expectations for key governance and primary risk management and internal control functions. Given the added element of foreign ownership, supervision of an FBO requires consideration of the manner in which governance and control functions for U.S. operations are integrated into the organization's global operations, as well as the home country supervisory framework under which the FBO operates. The Federal Reserve will supplement its knowledge of these factors by engaging in discussions with the home country supervisor and building upon that supervisor's insights on key governance and control functions as they impact U.S. operations.

Key governance and control functions for the U.S. operations of FBOs may be implemented locally or outside the United States, and the Federal Reserve will maintain an understanding and assessment of these functions regardless of where they are located. In instances where these functions are performed outside the United States, the established oversight mechanisms, governing policies and procedures, and supporting infrastructure must be sufficiently transparent for U.S. supervisors to assess their adequacy. Further, the FBO's U.S. management must demonstrate that it provides sufficient information flows to foreign governance and control functions, and that responsible senior management (including in the home country) maintain a thorough understanding of the risk and control environment governing U.S. operations. U.S.

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<sup>1</sup> 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 (IBA) 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.

<sup>2</sup> See Attachment C for definitions of terms commonly used in this document.

<sup>3</sup> Generally, "booked in" means recorded on the books and records of the legal entity in question. "Traded through" means transacted or arranged by the personnel of the organization in question (in an agent role) but booked at a different related legal entity.

management also is expected to assess the effectiveness of established governance and control mechanisms on an ongoing basis, including processes for reporting and escalating areas of concern and the implementation of corrective action as necessary.

As outlined in the following sections, a range of continuous monitoring activities are utilized, along with discovery reviews and testing activities (examination activities), to develop and maintain an understanding and assessment of the combined U.S. operations of large complex FBOs.

#### ***A. Federal Reserve Activities and Those 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 FBO's combined U.S. operations depends largely on the extent to which other relevant domestic primary supervisors, functional regulators, or home country supervisors 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 U.S. nonbank affiliates<sup>4</sup> of U.S. banking offices that are not functionally regulated – typically will require more independent Federal Reserve supervisory work. Other areas – such as primary risk management and control functions for U.S. operations – typically will require a greater degree of coordination with other relevant domestic primary supervisors, functional regulators, or home country supervisors, 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 domestic primary supervisors, functional regulators, and home country supervisors, an understanding and assessment of an FBO's U.S. operations. 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 domestic primary supervisors, functional regulators, and home country supervisors, including the information and assessments reflected in the reports of examination of such supervisors and functional regulators;
- Focus its supervisory activities on the combined U.S. operations, as well as on those of U.S. nonbank affiliates that could have a direct or indirect materially adverse effect on the safety and soundness of a U.S. banking office<sup>5</sup> due to the size, condition, or activities of the nonbank affiliate, or the nature or size of its transactions with the banking office; and
- Use publicly reported information (including externally audited financial statements) where available, as well as reports that an FBO or its affiliates

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<sup>4</sup> “U.S. nonbank affiliates” of U.S. banking offices are 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.

<sup>5</sup> “U.S. banking offices” are U.S. depository institution subsidiaries of FBOs and U.S. branches/agencies of FBOs.

prepares for other domestic primary supervisors, functional regulators, home country supervisors, or self-regulatory organizations.

### ***B. Functionally Regulated Subsidiaries***

As discussed below, in certain situations, the Federal Reserve may find it necessary to conduct an examination of a functionally regulated U.S. nonbank subsidiary of a large complex FBO in order to fulfill the Federal Reserve's responsibilities as supervisor of the combined U.S. operations. 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 letter 00-13. 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 combined U.S. operations that may pose a direct or indirect threat to the safety and soundness of a U.S. banking office.<sup>6</sup>

## **II. Understanding the Organization**

For each large complex FBO, the Federal Reserve will develop an understanding of the FBO's legal, operating, and governance structure in the United States, as well as its primary strategies, business lines, funding and liquidity sources, and risk management and internal control functions. This understanding will inform the development of a risk assessment and supervisory plan for the organization's U.S. operations. In addition, the Federal Reserve will maintain an understanding of certain aspects of the consolidated FBO, including its ownership and organizational structure, strategy, financial profile, and aspects of its operating environment, including its home country supervisory system and accounting practices.<sup>7</sup>

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<sup>6</sup> The Federal Reserve also may examine a functionally regulated subsidiary of a U.S. BHC that is part of a large complex FBO's U.S. operations 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 banking office, 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 banking offices).

Similarly, before requiring a specialized report from a functionally regulated subsidiary of a BHC, 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 (i) a material risk to the BHC or any of its depository institution subsidiaries, (ii) 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 (iii) compliance with any federal law that the Federal Reserve Board has specific jurisdiction to enforce against the BHC or a subsidiary.

<sup>7</sup> This understanding is formally documented during development of the institutional overview and strength-of-support assessment (SOSA), and supporting reviews of the home country financial system and accounting practices. SR letter 00-14, "Enhancements to the Interagency Program for Supervising the U.S.

Typically, the information necessary to gain this understanding may be obtained from the organization's U.S. management, public reports, regulatory reports, surveillance screens, third-party sources (e.g., credit rating agency and market analyst reports), and other relevant domestic primary supervisors or functional regulators. As necessary, this understanding may be supplemented by information obtained through other sources, such as the FBO's home country supervisor and corporate management at the FBO's headquarters.

Key elements that should be identified and understood include the following:

*U.S. Operations*

- Strategy. Primary U.S. 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 U.S. 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. U.S. business line and legal entity structure; domestic and foreign regulatory responsibilities for legal entities and business lines; key interrelationships and dependencies between U.S. banking offices 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.
- Governance, risk management, and internal controls for primary risks to U.S. operations. Governance of U.S. operations (regardless of location), including head office, regional, and local (country) oversight; reporting relationships between U.S. operations and the FBO's head office; information flows to the head office and home country supervisor; and key risk management and internal control functions, and associated management information systems (MIS), to manage primary activities and risks in the United States.
- Funding and liquidity. Funding and liquidity structure, policies, and practices for U.S. operations; reliance on the parent FBO (including net due to/from

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Operations of Foreign Banking Organizations," describes preparation for FBOs of the institutional overview and SOSA (including supporting reviews of the home country financial system and accounting practices), which coincides with creation of the annual risk assessment. SR letter 99-15, "Risk-Focused Supervision of Large Complex Banking Organizations," and SR letter 97-24, "Risk-Focused Framework for Supervision of Large Complex Institutions," describe processes for developing a risk assessment and supervisory plan which are kept current to reflect significant changes in an FBO's risks or activities.

positions<sup>8</sup>) and affiliates; and reliance on third-party funding sources such as U.S. debt markets.

- Presence in critical or key financial markets.<sup>9</sup> For the U.S. operations, identification of core clearing and settlement activities; business lines with a significant presence in critical or key national or global financial markets; and related risk management practices.

#### *Head Office and Home Country*

- Overview of the consolidated FBO. General understanding of the ownership and organizational structure; principal global business lines and areas of growth; business strategy, including presence in critical or key global financial markets; and financial profile, including capital structure, funding sources, and market ratings.
- Home country supervisory system. General understanding of primary elements of home country supervision and regulation, including approaches, policies, and practices for oversight of activities on a consolidated basis; and extent of reliance on U.S. supervisors.
- Home country financial system. General understanding of the FBO's home country operating environment; and accounting and financial reporting policies and practices with the potential to influence the supervisory strategy for U.S. operations.

To ensure the quality and consistency of supervision across the large complex FBO 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.

### **III. Assessing the Combined U.S. Operations**

An evaluation of the combined U.S. operations for each large complex FBO with multiple U.S. operations is developed at least annually and communicated to the FBO and its home country supervisor. The Federal Reserve will utilize the RFI (Risk Management, Financial Condition, and Impact) rating framework<sup>10</sup> as an analytical tool to develop the single-component Combined U.S. Operations rating.<sup>11</sup>

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<sup>8</sup> 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.

<sup>9</sup> See sections III.A.6 and III.A.7 for definitions of “key financial markets” and “critical financial markets.”

<sup>10</sup> See SR letter 04-18, “Bank Holding Company Rating System,” for more information about the RFI rating system for U.S. bank holding companies.

<sup>11</sup> SR letter 00-14 describes assignment of a rating for the combined U.S. operations. While the RFI framework will be utilized as an analytical tool to develop the Combined U.S. Operations rating, RFI

Consistent with the process for assigning an RFI rating for a BHC, the Combined U.S. Operations rating is not derived as a simple numeric average of the underlying RFI components; rather, it reflects supervisory judgment with respect to the relative importance of each component to the safety and soundness of the combined U.S. operations. This concept is particularly relevant to the Financial Condition (F) component, which, depending on the structure of the U.S. operations, may have less significance to the overall assessment, such as when the FBO's U.S. presence is largely concentrated in branch or agency operations.

#### ***A. Risk Management***

##### **1. Key Governance Functions for U.S. Operations**

*Objectives:* One of the primary areas of focus in the supervision of the combined U.S. operations of a large complex FBO is the adequacy of the governance function for U.S. operations established by the board of directors (board) or equivalent and senior management. The culture, expectations, and incentives established by these governance functions set the tone for the organization, and are essential determinants of whether an FBO is capable of maintaining fully effective risk management and internal control processes for its U.S. operations.

Regardless of where they are located, senior FBO management with responsibility for the governance functions for the FBO's U.S. operations is expected to maintain an ongoing understanding of key inherent risks, associated trends, and primary control functions, as well as demonstrate leadership, expertise, and effectiveness. Primary expectations for these senior FBO officers include:

- a) Selecting competent senior managers with qualifications and experience commensurate with the size and complexity of U.S. operations, ensuring that they have the proper incentives to conduct U.S. operations in a safe and sound manner, and regularly evaluating the performance of U.S. management;
- b) Establishing, communicating, and monitoring institutional risk tolerances and a culture across U.S. operations that emphasizes the importance of compliance with the law and ethical business practices;
- c) Establishing effective oversight and an appropriate risk culture;
- d) Approving significant strategies and policies;
- e) 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;
- f) 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;

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component ratings will not be assigned to the combined U.S. operations of FBOs. RFI ratings will, however, continue to be assigned to U.S. bank holding company subsidiaries of FBOs.

- g) Establishing and implementing incentives for personnel that are consistent with institutional risk tolerances, compliance with the law, and ethical business practices;
- h) 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;
- i) Ensuring receipt and review by appropriate levels of senior management and, if appropriate, the board (or its equivalent) of timely, accurate, and comprehensive MIS reports that are adaptive to changing circumstances regarding risks and controls;
- j) Implementing an effective independent internal audit program for U.S. operations; and
- k) Ensuring timely resolution of audit, compliance, and regulatory issues.

An effective internal audit program for U.S. operations plays an essential role by providing an independent and objective evaluation of all key governance, risk management, and internal control processes that affect U.S. operations. 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 FBO's U.S. operations.

*Supervisory activities:* For the combined U.S. operations of each large complex FBO, the Federal Reserve will understand and assess the adequacy of management oversight, as well as the adequacy of internal audit and associated MIS, regardless of where these functions are located. The Federal Reserve also will understand and assess other key governance functions (e.g., finance and treasury functions) whose effectiveness is essential to sustaining the combined U.S. operations of an FBO, as well as the organization's business resiliency and crisis management capabilities.

- Senior FBO officers with responsibility for key governance functions. Continuous monitoring activities of U.S. operations – 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 senior FBO officers with responsibility for key governance functions for U.S. operations. The Federal Reserve will supplement its knowledge by engaging in discussions with home country supervisors and building upon their insights on firmwide corporate governance functions and their impact on U.S. operations.

The results of continuous monitoring activities, as documented in the institutional overview, risk assessment, and other supervisory products, may

identify certain governance functions that will require more intensive supervisory focus due to (i) significant changes in U.S. strategy, activities, organizational structure, oversight mechanisms, or key personnel; (ii) potential concerns regarding the adequacy of a specific U.S. governance function; or (iii) the absence of sufficiently recent examination activities for a key function by the Federal Reserve or another domestic primary supervisor, functional regulator, or home country supervisor.

- Internal audit. Continuous monitoring and examination activities will be used to understand and assess key elements of internal audit for U.S. operations, including the extent of oversight by governance functions; the independence, professional competence, and quality of the internal audit program; the quality and scope of the audit methodology, audit plan, and risk assessment process; and 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 for U.S. operations, 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 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 domestic primary supervisors or functional regulators (where applicable) in developing discovery reviews or testing activities focusing on the area of concern. In situations where another domestic primary supervisor or functional regulator leads the examination activities, the Federal Reserve will participate as actively as appropriate in those activities.<sup>12</sup>

If the area of concern is not within the oversight of another domestic 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 domestic primary supervisors and functional regulators to the extent possible.

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<sup>12</sup> Active participation by the Federal Reserve in an examination 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.

When senior FBO officers with responsibility for key governance functions or internal audit for U.S. operations are located outside the United States, the Federal Reserve will supplement its understanding through discussions with these officers and other overseas management as necessary, and will work with the home country supervisor to address information gaps or areas of concern.

- 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 domestic 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. As stated earlier, the scope of the testing program is limited to coverage of U.S. operations.

When the primary internal audit infrastructure for U.S. operations is located outside the United States, the Federal Reserve will assess this function by reviewing audit scopes, reports, workpapers, and other associated MIS (including, if necessary, requesting that information relevant to the U.S. operations be provided even if this information is not normally available in the United States), and through discussions with overseas management of internal audit. These activities should be supplemented as necessary by discussions with, and information gathered from, the home country supervisor, based on examination or other verification activities they may conduct.

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 I.B.

## 2. Risk Management and Internal Control Functions for Primary Risks to Combined U.S. Operations

*Objectives:* Underlying the risk-focused approach to supervision of the U.S. operations of large complex FBOs is the premise that it is each FBO's responsibility to develop an appropriate control structure for identifying, measuring, monitoring, and controlling key risks of its U.S. operations 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 combined U.S. operations of large complex FBOs (primary risk management and control functions), and associated MIS, regardless of where these functions are conducted. This will include risk management and control functions for primary credit, legal and compliance,<sup>13</sup> liquidity, market, and operational risks for

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<sup>13</sup> Federal Reserve processes for understanding and assessing legal and compliance risk management apply to the U.S. operations of large complex FBOs and, as described in SR letter 03-22/CA letter 03-15,

combined U.S. operations. The Federal Reserve also will understand and assess other risk management and control mechanisms that, based on the specific characteristics and activities of the FBO's U.S. operations, relate to primary risks to such operations as a whole.

For example, for large complex FBOs with particularly dynamic strategies for U.S. operations, 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 FBOs 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 FBOs, 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 risk management or control mechanism for U.S. operations depends on the appropriateness of the following:

- a) Control infrastructure and governance, including degree of oversight by senior FBO officers with responsibility for U.S. operations;
- b) Development, maintenance, and communication of appropriate policies, procedures, and internal controls;
- c) 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, if appropriate, the board (or its equivalent);
- d) Monitoring and testing the effectiveness of controls;
- e) Processes for identifying, reporting, and escalating issues and emerging risks;
- f) Ability to implement corrective actions in a timely manner;
- g) Appropriate authority and independence of staff to carry out responsibilities; and
- h) Integration of risk management and control objectives within management goals and the organization's compensation structure.

Most large complex FBOs 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 for managing risks and activities on a global, regional, and local (country) level, and in some instances there is not a firmwide mechanism in place to oversee and manage a key control function across the FBO's business lines and legal entities. In all instances, the Federal Reserve will focus on individual control structures for U.S. business lines or

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<sup>1</sup>“Framework for Assessing Consumer Compliance Risk at Bank Holding Companies,” encompass consumer compliance risk inherent in U.S. BHCs of these FBOs.

legal entities as needed to reach an understanding and assessment of such approaches to controlling primary risks to the combined U.S. operations.

*Supervisory activities:* The Federal Reserve will use continuous monitoring activities to understand and assess each primary risk management and control function for U.S. operations, regardless of where these functions are located. This process begins with the overarching design and architecture of each primary risk management or control function for U.S. operations, and drills down, as appropriate, through analysis of risk management and controls for material portfolio areas and business lines (described in section III.A.3 below). Activities will verify the sufficiency of fundamental aspects of internal controls in relation to the current risk profile of U.S. operations and in comparison with supervisory expectations and evolving sound practices, and assess the capability of these control 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 Federal Reserve will supplement its knowledge by engaging in discussions with the home country supervisor and building upon its insights with regard to risk management and control functions as these functions impact U.S. operations.

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

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

If the primary risk management or control function is not within the oversight of another domestic primary supervisor or functional regulator, or if the domestic 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 I.B.

When U.S. activities are supported by a primary risk management or control function located outside the United States, the Federal Reserve will supplement its understanding of the control environment for U.S. operations through discussions with overseas management, as necessary, and will work with the home country supervisor to address information gaps or areas of concern.

### 3. Risk Management of Material Portfolios and Business Lines

*Objectives:* For each large complex FBO there are selected portfolio risk areas (such as wholesale credit risk or personal financial services) or individual business lines (such as leveraged lending or international private banking) that are primary drivers of risk or revenue for U.S. operations, or that otherwise materially contribute to understanding inherent risk or assessing the adequacy of controls within the combined U.S. operations.

During the development of the SOSA, institutional overview, and risk assessment, as well as during other supervisory processes, the Federal Reserve will analyze external factors and internal trends in the FBO's U.S. strategic initiatives – as evidenced by budget and internal capital allocations (where applicable) and other factors – to identify significant activities and areas vulnerable to volatility in revenue, earnings, liquidity, or capital (where applicable) that represent material risks of its U.S. operations. This determination of material U.S. portfolios and business lines considers all associated risk elements, including legal and compliance risks. For example, when evaluating whether wholesale credit activities such as leveraged lending are material to the U.S. operations of an FBO, the extent of inherent legal 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 risk management and control functions for combined U.S. operations (as discussed in preceding section III.A.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 domestic primary supervisor or functional regulator where the FBO's legal and operating structure in the United States 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 primary risk management and control functions for U.S. operations.

Many U.S. activities of large complex FBOs span legal entities that are subject to oversight by multiple domestic supervisors or regulators, or that are outside the oversight of other domestic supervisors or regulators. If this is the case, or if the domestic 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 domestic 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 I.B.

#### 4. Risk Management of Nonmaterial Business Lines

*Objectives:* For nonmaterial U.S. business lines of a large complex FBO that are identified during the development of the SOSA, 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 domestic primary supervisor or functional regulator has a sufficient view of nonmaterial U.S. 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 U.S. operations of the FBO.

For nonmaterial U.S. business lines that are not subject to oversight by a single domestic 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 I.B 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 U.S. operations of the FBO.

#### 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 U.S. core clearing and settlement organizations.<sup>14</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

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<sup>14</sup> 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 letter 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 III.A.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).

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 (i) a significant change in inherent risk for U.S. core clearing and settlement activities stemming from changing strategies or activities; (ii) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk management or internal controls; or (iii) 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 domestic 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 ensuring that risk management and control functions are appropriately designed and achieving their intended objectives. In situations where another domestic primary supervisor or functional regulator leads the discovery review or 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 domestic 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 domestic 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 domestic 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's U.S. operations to the resilience or fragility of the clearance and settlement system as a whole, and on adherence by the organization's U.S. operations 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 I.B.

When the primary infrastructure for risk management and internal controls associated with U.S. core clearing and settlement activities is located outside the United States, the Federal Reserve will assess these functions by reviewing associated MIS (including, if necessary, requesting that information relevant to the U.S. operations be provided even if this information is not normally available in the United States), and through discussions with overseas management. These activities should be supplemented as necessary by discussions with, and information gathered from, the home country supervisor, based on examination or other verification activities they may conduct.

## 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 a large complex FBO's U.S. 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 FBO's U.S. combined assets or revenues. These business lines are subject to special supervisory focus by the Federal Reserve in light of their potential to transmit a collective adverse impact across multiple organizations and financial markets and the resulting significant 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 (i) a significant change in inherent risk stemming from changing strategies or activities; (ii) a significant change in organizational structure, oversight mechanisms, key personnel, or other key elements of related risk management or internal controls; or (iii) 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 domestic 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 domestic 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 domestic primary supervisor or functional regulator, or if the domestic 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 domestic 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 domestic 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 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 I.B.

When the primary infrastructure associated with meeting expectations of the interagency sound practices paper is located outside the United States, the Federal Reserve will assess these functions by reviewing associated MIS (including, if necessary, requesting that information relevant to the U.S. operations be provided even if this information is not normally available in the United States), and through discussions with overseas management. These activities should be supplemented as necessary by discussions with, and information gathered from, the home country supervisor, based on examination or other verification activities they may conduct.

## 7. Risk Management of Activities in Key Financial Markets

*Objectives:* To be designated as an LCBO by the Federal Reserve, an FBO must meet specified criteria as a significant participant in at least one key financial market.<sup>15</sup> For each key financial market activity where the large complex FBO 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 potential impact of their U.S. operations 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 domestic primary supervisor or functional regulator where the FBO's U.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 domestic 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 domestic supervisors or regulators, or that are outside the oversight of other domestic supervisors or regulators, the Federal Reserve will develop and conduct – in coordination with other relevant domestic primary supervisors and functional regulators to the extent possible and in accordance with the provisions described above in section I.B if relevant – testing and discovery review activities as necessary to complement continuous monitoring work.

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<sup>15</sup> “Key financial markets” include the critical financial markets defined in section III.A. 6 above, as well as (i) broader U.S. capital market activity, including underwriting, securitization, derivatives, and trading; (ii) retail financial services; and (iii) international financial markets. Each LCBO meets at least one of these key market thresholds.

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:

- a) 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;
- b) 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;
- c) 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
- d) 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 risk officers, 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>16</sup>

These activities will be designed and conducted in coordination with other relevant domestic primary supervisors and functional regulators to the fullest extent possible and in accordance with the provisions described above in section I.B. 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.

#### **9. Funding and Liquidity Management of U.S. Operations**

*Objectives:* Consideration of a parent FBO's funding and liquidity profile is a central element in developing an understanding and assessment of an FBO's ability to provide the necessary financial and managerial support to its U.S. banking offices. The SOSA is the primary tool used by the Federal Reserve to evaluate parent company funding and liquidity, reflecting analysis of the FBO's capital structure, funding profile, the level of transfer risk, market ratings, and other factors.

Beyond the SOSA analysis, there are additional factors that are central to understanding and assessing the funding and liquidity management of U.S. operations for large complex FBOs, and in formulating related supervisory activities. These include:

- a) Funding and liquidity structure of U.S. operations, including reliance on the parent FBO and affiliates (including net due to/from positions), and third-party funding sources such as U.S. debt markets.
- b) Whether there are cross-border, cross-jurisdictional, or other legal restrictions that would negatively impact the ability of the parent to provide liquidity and funding support to its U.S. operations. Included in this analysis is the parent's ability to provide financial and managerial support to U.S. banking offices during periods of financial stress or adversity.
- c) Liquidity management policies and practices of U.S. operations, including whether liquidity management is undertaken at a global, regional, or country level, and whether liquidity management is conducted on a legal-entity or business-line basis.
- d) The sufficiency, reliability, and timeliness of MIS reports related to funding and liquidity of U.S. operations.
- e) 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 incorporate business line information into assessments of actual and contingent liquidity risk.

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<sup>16</sup> 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.

- f) Whether funds management practices for U.S. operations provide sufficient funding flexibility to respond to unanticipated, evolving, and potentially correlated market conditions for the organization and/or across financial markets.
- g) The sufficiency of liquidity planning tools for U.S. operations, such as stress testing, scenario analysis, and contingency planning efforts, including
  - (i) 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; (ii) 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 (iii) 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).
- h) Intraday liquidity management policies and practices, and compliance with the “Federal Reserve Policy on Payments System Risk”,<sup>17</sup> including expectations for U.S. banking offices 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 U.S. banking offices of large complex FBOs, as in many instances these entities represent the FBO’s primary and most active vehicles for U.S. external funding and liquidity management. The domestic primary supervisor retains responsibility for assessing liquidity risk management practices with respect to the U.S. banking office.

Where a large complex FBO’s U.S. BHC parent company or nonbank affiliate plays a significant role in directly accessing market sources and/or managing funding requirements for all or significant portions of U.S. operations, particular attention should also be given to the following areas:

- a) The ability of the BHC parent company and nonbank affiliates to maintain sufficient liquidity, cash flow, and capital strength<sup>18</sup> to service their debt obligations and cover fixed charges;

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<sup>17</sup> This policy statement is available on the Board’s public website at: <http://www.federalreserve.gov/paymentsystems/psr/default.htm>

<sup>18</sup> As outlined in SR letter 01-1, “Application of the Board’s Capital Adequacy Guidelines to Bank Holding Companies owned by Foreign Banking Organizations,” in cases in which the Federal Reserve Board has determined that a foreign bank operating a U.S. branch, agency, or commercial lending company is well-capitalized and well-managed under standards that are comparable to those of U.S. banks controlled by financial holding companies (FHCs), the presumption will be that the foreign bank has sufficient financial strength and resources to support its banking offices in the United States. Thus, as a general matter, a U.S. BHC that is owned and controlled by a foreign bank that is an FHC that the Federal Reserve Board has determined to be well-capitalized and well-managed will not be required to comply with the Federal Reserve Board’s capital adequacy guidelines.

- b) The likelihood that BHC parent company or nonbank funding strategies could undermine public confidence in the liquidity or stability of subsidiary depository institutions;
- c) Policies and practices that are aimed at ensuring the stability of BHC 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; and
- d) The extent of “double leverage”<sup>19</sup> and the organization’s capital management policies, including the distribution and transferability of capital across jurisdictions and legal entities.

*Supervisory activities:* The Federal Reserve will use continuous monitoring activities – including monitoring market conditions and indicators where available, as well as ongoing dialogue with the FBO and home country supervisor – and discovery reviews to understand and assess the liquidity and funding capacity of U.S. operations, including the ability to meet anticipated and potential liquidity needs. An understanding of foreign parent company support will be updated at least annually as part of the SOSA preparation, and on at least an annual basis the results of these supervisory activities for U.S. operations will be reviewed to determine whether there is (i) a significant change in inherent funding or liquidity risk stemming from changing strategies or activities; (ii) a significant change in the structure, oversight mechanisms, or other key elements of related risk management or internal controls; or (iii) 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 domestic primary supervisors or functional regulators (where applicable) to design testing activities focused on understanding and assessing areas of change and/or concern in order to ensure that funding and liquidity risk management and control functions for U.S. operations are appropriately designed and achieving their intended objectives.

In all instances, the Federal Reserve will conduct testing activities (either by leading the activities and coordinating with other relevant domestic 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, assessing each element of funding and liquidity risk management for U.S. operations, including management oversight; policies, procedures, and limits; risk monitoring and management information systems; and internal controls. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section I.B.

For a large complex FBO with a U.S. banking office that has a self-assessed net debit cap, the Federal Reserve will conduct an annual review of the self-assessment file to

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<sup>19</sup> “Double leverage” refers to situations in which debt is issued by the parent company and the proceeds are invested in subsidiaries as equity.

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 domestic primary supervisors, or participate as actively as appropriate in the related work of such supervisors.

When the primary infrastructure for risk management and internal controls associated with funding and liquidity of U.S. operations is located outside the United States, the Federal Reserve will assess these functions by reviewing associated MIS (including, if necessary, requesting that information relevant to the U.S. operations be provided even if this information is not normally available in the United States), and through discussions with overseas management. These activities should be supplemented as necessary by discussions with, and information gathered from, the home country supervisor, based on examination or other verification activities they may conduct.

## ***B. Financial Condition***

### ***1. Combined U.S. Operations***

*Objectives:* Assessment of the financial condition of the combined U.S. operations of a large complex FBO is supported by analyzing the four “CAEL” elements: Capital Adequacy (C), Asset Quality (A), Earnings (E), and Liquidity (L).<sup>20</sup> These elements can be evaluated along individual business lines, product lines, or on a legal-entity basis depending on what is most appropriate given the structure and organization of U.S. operations. The assessment of CAEL elements should utilize benchmarks and metrics appropriate to the business activity being evaluated.

- Capital Adequacy. (C) reflects the adequacy of the combined capital position of U.S. operations, focusing on regulatory capital calculation methodologies and the FBO’s internal assessments of capital adequacy, where applicable. This analysis considers the adequacy of capital at each separately capitalized entity in the United States that is subject to regulatory capital requirements. The capital adequacy of significant nonbank affiliates not subject to regulatory capital requirements should also be reviewed and factored into the analysis to the extent possible using available internal and industry data.

In most circumstances, parent FBO capital is not reflected in this analysis, except to the extent that an assessment of capital is necessary for compliance with the well-capitalized standard for FHCs. However, if U.S. operations have recently required parent company capital injections – or if a need for such parent company support is anticipated in coming months – then the ability and confirmed willingness of the parent company to provide such support should be considered in the analysis of the financial condition of the combined U.S. operations.

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<sup>20</sup> See SR letter 04-18 for more information about the CAEL subcomponents. While review of the CAEL elements will be used as an analytical tool in assessing the financial condition of a large complex FBO’s combined U.S. operations, individual CAEL subcomponent ratings will not be assigned as part of the Combined U.S. Operations rating.

Branches and agencies do not maintain separate capital and, as such, are excluded from the analysis of capital adequacy.

- Asset Quality. (A) reflects the quality of the combined assets of U.S. operations. The analysis of asset quality should include a consideration of the asset quality assessments developed by domestic primary supervisors at each U.S. banking office, as well as any asset quality analysis performed by functional regulators at individual nonbank affiliates. If a U.S. nonbank affiliate poses significant credit risk, the analysis should include an understanding and assessment of asset quality at that entity.
- Earnings. (E) reflects the quality and quantity of the combined earnings of U.S. operations. The analysis should include a consideration of earnings performance at each separately capitalized entity, as well as an analysis of revenue and earnings at branches/agencies that are material to the U.S. operations. When analyzing branch/agency earnings, significant weight may be placed on management objectives and performance metrics. Consideration should be given to the level, trend, and sources of earnings, including how such earnings support U.S. operations and the overall goals and objectives of the parent organization.
- Liquidity. (L) reflects the ability of the combined U.S. operations to attract and maintain the funds necessary to support operations and meet obligations on an ongoing basis.<sup>21</sup> Accordingly, the analysis should include a consideration of balance sheet liquidity on a combined basis, if available, or at each legal entity (adjusted for materiality). Foreign parent company support as a ready and viable source of funds (particularly for branches/agencies) – including the likelihood that a downgrade in the parent’s market ratings could lead to an increased cost of funds and/or diminished access to liquidity for U.S. operations – should also be considered in this analysis.

*Supervisory activities:* The Federal Reserve will primarily utilize continuous monitoring activities to assess the financial strength of the combined U.S. operations of an FBO. Such activities will include periodic meetings with the FBO’s U.S. management; review of regulatory reports, surveillance screens, and internal MIS; and analysis of available market indicators. Testing and discovery activities will be used as necessary to assist in the understanding and assessment of areas of concern. In all cases involving a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section I.B.

When primary mechanisms for managing material financial aspects of the FBO’s combined U.S. operations are located outside the United States, the Federal Reserve will supplement its understanding of these mechanisms through discussions with overseas

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<sup>21</sup> Assessing liquidity levels and funding practices for combined U.S. operations may also incorporate elements presented in section III.A.9 above on “Funding and Liquidity Management of U.S. Operations.”

management as necessary, and will work with the home country supervisor to address information gaps or areas of concern.

## 2. U.S. Bank Holding Company Subsidiary of a Large Complex FBO

*Objectives:* Large complex FBOs may have a U.S. BHC within the structure of their U.S. operations. The Federal Reserve's evaluation of a BHC's consolidated financial strength focuses on the ability of the organization's resources to support the level of risk associated with its activities, with assessments developed for each CAEL subcomponent of the Financial Condition rating.

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

- a) The sufficiency of the U.S. 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;
- b) The capability of liquidity levels and funds management practices to allow reliable access to sufficient funds to meet present and future liquidity needs; and
- c) 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 III.C below.

In assessing consolidated regulatory capital,<sup>22</sup> the Federal Reserve looks to ensure that the U.S. 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>23</sup> that influence this assessment. This assessment utilizes results from examinations led by the Federal Reserve or other domestic primary supervisors or functional regulators, as well as information gained from the BHC's internal control functions and from market-based assessments, where available.

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. Some large complex BHCs controlled by an FBO 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>24</sup> For these organizations, the Federal Reserve focuses on whether internal processes for assessing capital adequacy ensure that all risks

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<sup>22</sup> Refer to footnote 18 regarding applicability of SR letter 01-1 as it pertains to capital adequacy guidelines for a U.S. BHC that is owned and controlled by a foreign bank that is an FHC.

<sup>23</sup> "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.

<sup>24</sup> See SR letter 99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles."

are properly identified, reliably quantified (where possible) across the entire BHC, and supported by adequate capital.

When assessing the adequacy of a U.S. BHC's liquidity levels and funds management practices, areas of focus include:<sup>25</sup>

- a) 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 incorporate business line information into assessments of actual and contingent liquidity risk;
- b) 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
- c) The sufficiency of liquidity planning tools, such as stress testing, scenario analysis, and contingency planning efforts, including (i) 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; (ii) 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 (iii) 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 U.S. BHC's consolidated financial condition depends largely on the extent to which other relevant domestic 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 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 will typically be required to assess consolidated asset quality and earnings.

*Supervisory activities:* The Federal Reserve will primarily utilize continuous monitoring activities to assess the financial strength of a U.S. BHC within the structure of an FBO's U.S. operations. 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 available market indicators. Testing and discovery activities will be used as necessary to assist in the understanding and assessment of areas of concern.

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<sup>25</sup> Assessing liquidity levels and funding practices for a U.S. BHC may also incorporate elements presented in section III.A.9 above on “Funding and Liquidity Management of U.S. Operations.”

Testing and discovery activities also will be used to understand and assess the sufficiency of the U.S. BHC's consolidated capital and liquidity positions to support the level of risk associated with its activities, including (i) regulatory capital calculation methodologies<sup>26</sup> and, where applicable, internal assessments of capital adequacy;<sup>27</sup> and (ii) funds management and liquidity planning tools and practices. The Federal Reserve will work with other relevant domestic 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 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 I.B.

### ***C. Impact***

#### **Risk Management and Financial Condition of Significant U.S. Nonbank Affiliates**

*Objectives:* Most large complex FBOs engage in activities and manage control functions on a global basis, spanning banking and nonbanking legal entities in the United States and abroad. These organizations often have considerable intra-group exposures and servicing arrangements across U.S. affiliates, presenting increased potential risks for U.S. banking offices and a higher likelihood of aggregate risk concentrations across the organization's U.S. legal entities. Common interactions between an FBO's U.S. banking offices and its U.S. nonbank affiliates include assets originating in, or being marketed by, a nonbank affiliate that are booked in a U.S. bank or branch; a banking office providing funding for nonbank affiliates; and risk management or internal control functions being shared between U.S. banking offices and nonbank affiliates.

Due to these interrelationships, financial, legal, or compliance troubles in one part of an FBO's U.S. operations can spread rapidly to other parts of the organization. Even absent these interactions, U.S. nonbank affiliates may present financial, legal, or compliance risk to the consolidated FBO, and thus directly or indirectly to the U.S. banking offices. FBOs conduct U.S. nonbank activities either through a direct office or subsidiary of the foreign parent company, or through a subsidiary of a U.S. BHC. The risks arising from the interrelationships described above can be present regardless of how U.S. nonbank activities are structured, and, as such, supervisory objectives and activities related to nonbank operations are similar in each case.

As the federal banking agency charged with supervising the combined U.S. operations of FBOs, the Federal Reserve is responsible for understanding and assessing the risks that U.S. nonbank affiliates of an FBO may pose to U.S. banking offices, or to the

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<sup>26</sup> Assessments of the adequacy of regulatory capital for BHC subsidiaries of FBOs 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 CFR 225, Appendix E) and the new advanced capital adequacy framework for BHCs (Regulation Y: 12 CFR 225, Appendix G).

<sup>27</sup> See SR letter 99-18.

consolidated organization's ability to provide support to its U.S. banking offices. The Federal Reserve's authority with respect to regulation and supervision of all U.S. nonbank activities of FBOs derives from the IBA, which imposed the nonbank activity restrictions of the Bank Holding Company Act (BHC Act) on the operations of FBOs in the United States. With certain exceptions, these are the same restrictions that apply to U.S. banking organizations.<sup>28</sup>

The primary objectives of Federal Reserve supervision of the U.S. nonbank operations of FBOs are to:

- a) Identify significant U.S. nonbank activities and risks – where a U.S. nonbank affiliate engages in risk-taking activities or holds exposures that are material to the risk management or financial condition of the U.S. banking offices or to the consolidated FBO – 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 U.S. banking offices;
- b) Evaluate the financial condition and the adequacy of risk management practices of material U.S. nonbank affiliates, including the ability of nonbank affiliates to repay advances provided by U.S. banking offices, using benchmarks and analysis appropriate for those businesses;
- c) Evaluate the degree to which U.S. nonbank affiliate risks may present a threat to the safety and soundness of U.S. banking offices, including through transmission of legal or compliance risks;
- d) Identify and assess any intercompany relationships, dependencies, or exposures – or aggregate concentrations – with the potential to threaten the condition of U.S. banking offices; and
- e) Evaluate the effectiveness of the policies, procedures, and systems that U.S. nonbank affiliates use to ensure compliance with applicable laws and regulations, including consumer protection laws.<sup>29</sup>

*Supervisory activities:* For all significant U.S. nonbank affiliates, the Federal Reserve will use continuous monitoring activities and discovery reviews to:

- Maintain an understanding of the FBO's U.S. business line and legal entity structure, including key interrelationships and dependencies between U.S. banking offices and nonbank affiliates, utilizing regulatory structure reports, internal MIS, and other information sources;

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<sup>28</sup> FBOs that are qualifying foreign banking organizations, or "QFBOs", are entitled to certain exemptions from the nonbanking activities restrictions of the BHC 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.

<sup>29</sup> 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.

- Understand and assess the exposure to, and tolerance for, legal and compliance risks, as well as the extent to which potential conflicts of interest are identified and avoided or managed;
- 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;
- Identify and assess key interrelationships and dependencies between U.S. banking offices and nonbank affiliates, such as the extent to which U.S. banking offices are reliant on services provided by U.S. nonbank affiliates and the reasonableness of associated management fees;
- Identify those U.S. nonbank affiliates whose activities present material financial, legal, or compliance risk to the consolidated FBO and/or a U.S. banking office;
- 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;
- 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 domestic primary supervisor) whether compliance issues are present;<sup>30</sup>
- Understand and assess the sufficiency, reliability, and timeliness of associated MIS relied upon by senior management and, if appropriate, the board (or its equivalent) to monitor key nonbank activities and risks; and
- Assist the home country supervisor in fulfilling its responsibilities by helping to verify that the flow of information to the home country supervisor is sufficient to enable it to assess the impact of U.S. nonbank affiliates on the parent FBO.

Periodic testing may be used to supplement continuous monitoring and discovery reviews to (i) ensure that key risk management and internal control practices conform to internal policies and/or are designed to ensure compliance with the law, and (ii) understand and assess operations presenting a moderate or greater likelihood of significant negative impact to a U.S. banking office or to the consolidated FBO. Areas of potential negative impact include financial or operational risks that pose a potential threat to the safety and soundness of a U.S. banking office, or to the consolidated FBO’s ability to serve as a source of financial and managerial strength to its U.S. banking offices. Testing will focus on controls for identifying, monitoring, and controlling such risks. In all cases involving

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<sup>30</sup> U.S. branches and agencies of FBOs are not subject to Regulation W, except for transactions within FBO financial holding companies with securities, insurance, and merchant banking affiliates.

a functionally regulated subsidiary, the Federal Reserve will conduct its activities in accordance with the provisions described above in section I.B.

When significant U.S. nonbank affiliates are supported by a primary risk management or control function located outside the United States, the Federal Reserve will supplement its understanding of the control environment for these U.S. operations through discussions with overseas management as necessary, and will work with the home country supervisor to address information gaps or areas of concern.

***D. Reflecting Direct Influence of Non-U.S. Operations in Analysis and Assessment of Combined U.S. Operations of Large Complex FBOs***

As noted previously, key governance and control functions for the U.S. operations of large complex FBOs may be implemented locally or outside the United States, and there are instances when elements of the CAEL analysis may need to reflect support or other areas of influence of the parent FBO on its U.S. operations. As such, the Federal Reserve's analysis of the Risk Management (R) and Financial Condition (F) – and in select cases the Impact (I) – subcomponent areas<sup>31</sup> for use in developing RFI ratings for U.S. BHCs of FBOs and the Combined U.S. Operations rating will reflect the direct influence of the FBO's non-U.S. operations on the FBO's U.S. operations.<sup>32</sup>

The following examples illustrate how non-U.S. operations may have a direct influence on the risk management or financial condition of a large complex FBO's U.S. operations:

**1. Risk Management**

- When strategic decisions regarding significant activities, risk identification, and controls for U.S. operations are made by non-U.S. based personnel, evaluation of elements of the processes for making such decisions as they specifically relate to U.S. operations is reflected in the analysis of “Board and Senior Management Oversight” for U.S. operations.
- When a non-U.S. affiliate bank is deemed by its supervisor to have material deficiencies in its policies and procedures for detecting and reporting suspicious activities, and the FBO's U.S. operations use common or similar policies and procedures, an analysis of whether the policies and procedures applicable to U.S. operations have similar deficiencies is reflected in the analysis of “Policies, Procedures and Limits” for U.S. operations.
- When credit risk measurement and monitoring for U.S. operations is performed by a non-U.S. affiliate, evaluation of elements of these non-U.S.

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<sup>31</sup> See SR letter 04-18 for more information about the RFI components and subcomponents.

<sup>32</sup> While the SOSA process – which provides insight into the overall financial viability of the FBO and the strength of its management oversight – represents a useful starting point in developing this analysis, evaluation of the direct influence of non-U.S. operations as they specifically relate to the FBO's U.S. operations requires a significantly more detailed and targeted understanding and evaluation of this linkage than is typically contained in the SOSA analysis.

controls as they specifically relate to U.S. operations is reflected in the analysis of “Risk Monitoring and MIS” for U.S. operations.

- When financial reporting for U.S. operations is developed by a non-U.S. affiliate, evaluation of elements of this non-U.S. function as it specifically relates to U.S. operations is reflected in the analysis of “Internal Controls” for U.S. operations.

## 2. Financial Condition

- When U.S. operations have recently required foreign parent company capital injections – or if a need for such parent company support is anticipated in coming months – the ability and confirmed willingness of the parent company to continue to provide necessary levels of support is reflected in the analysis of “Capital Adequacy” for U.S. operations.
- When a foreign parent company encounters financial difficulties with a subsequent downgrade in market ratings, the analysis of “Liquidity” for U.S. operations will evaluate the likelihood that the downgrade could lead to an increased cost of funds and/or diminished access to liquidity for U.S. operations.

## 3. Impact

As with domestic BHCs, the (I) rating component for U.S. BHC subsidiaries of FBOs reflects the potential negative impact of the FBO’s U.S. BHC parent company and its nondepository subsidiaries on the BHC’s subsidiary depository institutions. Similarly, the impact analysis for the U.S. operations of FBOs reflects the potential negative impact of U.S. nonbank affiliates on U.S. banking offices.

In certain instances, this analysis of potential negative impact may reflect the direct influence of non-U.S. operations on the FBO’s U.S. nonbank affiliates, and thus directly or indirectly on U.S. banking offices, as reflected in the following example:

- When a significant U.S. nonbank affiliate receives ongoing foreign parent company financial and/or managerial support, the ability and confirmed willingness of the parent company to continue to provide such support is reflected in the analysis of the potential “Impact” of the organization’s U.S. nonbank affiliates on U.S. banking offices. In this instance, confirmation of the parent company’s continued support for this U.S. nonbank affiliate serves as a risk mitigant when evaluating the likelihood of negative impact on the FBO’s U.S. banking offices.

## IV. **Interagency Coordination**

### ***A. 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>33</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 III, in understanding and assessing the activities and risks of the combined U.S. operations of a large complex FBO, the Federal Reserve will rely to the fullest extent possible on the examination and other supervisory work conducted by the domestic primary supervisors and functional regulators of an FBO's U.S. operations. 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 governance functions, risk management and internal control functions for primary risks, financial condition, and other areas of combined U.S. operations as applicable.

*Supervisory activities.* The Federal Reserve will continue to work with the relevant domestic primary supervisors and functional regulators of a large complex FBO's U.S. operations to ensure that the necessary information flows and coordination mechanisms exist to permit the effective supervision of the combined U.S. operations. The Federal Reserve will continue to share information, including confidential supervisory information, obtained or developed through its consolidated supervisory activities with other relevant domestic primary supervisors or functional regulators when appropriate and permitted by applicable laws and regulations.<sup>34</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 domestic 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;

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<sup>33</sup> Section IV.B below discusses cross-border cooperation and information sharing among foreign supervisors.

<sup>34</sup> Among the federal laws that may limit the sharing of information among supervisors are the Right to Financial Privacy Act (12 USC 3401 *et seq.*) and the Trade Secrets Act (18 USC 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.*).

- Bilateral exchanges of letters to facilitate information sharing on a situation-specific basis;
- Periodic and as-needed contacts with domestic 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>35</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.

Coordination of Examination Activities at a Supervised U.S. Banking Office or Subsidiary

As discussed in section III, the Federal Reserve will seek to work cooperatively with the relevant domestic primary supervisor or functional regulator to address information gaps or indications of weakness or risk identified in a large complex FBO's U.S. operations that are material to the Federal Reserve's understanding or assessment of the risks, activities, or key governance, risk management, or control functions across the combined U.S. operations. Prior to conducting discovery reviews or testing activities at a U.S. banking office (other than where the Federal Reserve is the primary federal supervisor) or functionally regulated subsidiary, the Federal Reserve will:

- Review available information sources as part of its continuous monitoring activities, including examination reports and the organization'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 domestic 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.

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<sup>35</sup> 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.

If, following these activities, the Federal Reserve's information needs or supervisory concerns remain, the Federal Reserve will work cooperatively with the relevant domestic primary supervisor or functional regulator in the manner discussed in section III above.<sup>36</sup>

### ***B. Cooperation and Information Sharing With Home Country Foreign Supervisors***

*Objectives:* Comprehensive, consolidated supervision of banking organizations with cross-border operations can only be conducted effectively if the home country supervisor has adequate information on the operations of its supervised entities, wherever conducted. Information sharing among domestic and foreign supervisors, consistent with applicable laws, is essential to ensuring effective consolidated supervision, and supervision of the U.S. operations of a large complex FBO requires cooperation and information exchange between home and host country supervisors.

The Federal Reserve has worked for many years with its counterparts from various countries to strengthen communication and cooperation as it relates to the supervision of banking organizations that operate across borders. These efforts have intensified in recent years and now take place on both a bilateral and multilateral 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 entered into information-sharing MOUs with numerous home country supervisors of FBOs. In addition, the Federal Reserve has developed effective working relationships with home country supervisors through periodic visits by System staff. These visits include banking industry discussions and strategy sessions focusing on individual FBOs and specific supervisory issues and initiatives. In addition to its longstanding cooperative relationships with home country supervisors, the Federal Reserve expects to increasingly participate, in its role as host country supervisor, 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.

*Supervisory activities:* A number of cross-border cooperation and information-sharing mechanisms are in place to support the Federal Reserve's host country supervision of the

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<sup>36</sup> As outlined in section III, 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.

combined U.S. operations of large complex FBOs, as well as each home country supervisor's consolidated supervision of an FBO's global operations. These include:

- As provided for throughout this guidance, the Federal Reserve regularly supplements its understanding and assessment of the U.S. operations of FBOs through discussions with the home country supervisor, and in certain circumstances will work with the home country supervisor to address information gaps or areas of concern.
- A copy of the Summary of Condition letter, which is addressed to the FBO's head office management, is shared with the home country supervisor (see SR letter 00-14). This letter highlights areas of overall strength and supervisory weaknesses in the FBO's combined U.S. operations, and also is used to disclose the FBO's Combined U.S. Operations rating and its SOSA ranking.
- The Federal Reserve responds to requests from home country supervisors for examination reports (on an ad hoc or flow basis) of the U.S. operations of an FBO. These reports, issued either solely by the Federal Reserve or jointly with another relevant supervisor, are shared with the home country supervisor after authorization in a redacted form and, as such, do not contain customer information. Authorization to share confidential supervisory information or customer information with a home country supervisor must be obtained from Federal Reserve Board staff.
- The Federal Reserve responds to requests by home country supervisors for certain qualitative information regarding the U.S. operations of FBOs, consistent with applicable law, to support their conduct of comprehensive, consolidated supervision. In addition, a home country supervisor may request to visit the U.S. offices of an FBO to conduct an onsite review and/or examination work, and to offer assistance and support. As the host authority, the Federal Reserve can facilitate such examinations, whether performed solely by the home country supervisor or on a joint basis with the Federal Reserve and/or another domestic primary supervisor.

### ***C. Indications of Weakness or Risk Related to U.S. Banking Offices***

*Objectives:* For areas beyond those specifically addressed in section III, there may be circumstances where the Federal Reserve has indications of material weakness or risk in a U.S. banking office of a large complex FBO, and it is not clear that the weakness or risk is adequately reflected in the assessment or supervisory activities of the domestic primary supervisor. Because a primary objective of supervision of an FBO's combined U.S. operations is to protect U.S. banking offices, the Federal Reserve will follow up with the appropriate domestic primary or foreign bank 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 U.S. banking office of an FBO (other than where the Federal Reserve is the primary federal supervisor) in an area beyond those

specifically addressed in section III, and it is not clear that the weakness or risk is adequately reflected in the assessment or supervisory activities of the domestic primary supervisor.

#### 1. Reliance on Information Obtained from the Domestic Primary Supervisor

- The Federal Reserve will first review available information sources (including, if necessary, requesting that information relevant to the U.S. operations be provided even if this information is not normally available in the United States, supplemented as necessary through discussions with personnel from the FBO's head office), discuss the areas of concern with the domestic primary supervisor, and seek to review the supervisor's related work.
- If concerns remain following these activities, the Federal Reserve will request that the domestic primary supervisor conduct a discovery review or testing activity at the U.S. banking office to address the area of concern.
- In the event the domestic 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 U.S. banking office 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.

#### 2. Reliance on Information Obtained from the Home Country Supervisor

If the indication of material weakness or risk involves a governance function, risk management function, or internal control process located outside the United States that supports the U.S. operation in question, the Federal Reserve will contact the home country supervisor to discuss the concern, request any supporting information, and possibly request additional activities that are important to developing an understanding or assessment.

The determination of whether discussions with the home country supervisor are sufficient to address the concern may depend on the structure of the U.S. operations in question. If the issue in question relates to a U.S. bank or significant nonbank affiliate, the Federal Reserve – in conjunction with other relevant domestic primary supervisors or functional regulators – may request that the home country supervisor conduct a discovery review or testing activities as necessary to address this area of material weakness or risk. However, if the issue relates to a U.S. branch/agency, then information and assessments already developed by the home country supervisor should be sufficient in most instances, and there will most likely not be a need to request additional supervisory activities.

When the responsible Reserve Bank identifies a need to request that the home country supervisor conduct additional activities to address an area of material weakness or risk, the Reserve Bank will coordinate communication of this request with Federal Reserve Board staff.

**D. Condition or Management of Supervised U.S. Operations is Less-than-Satisfactory**

*Objectives:* As noted above, a primary responsibility of the Federal Reserve as host country supervisor for the combined U.S. operations of large complex FBOs is to ensure that the FBO's activities, policies, and practices do not undermine its ability to serve as a source of financial and managerial strength to its U.S. banking offices. In situations where the condition or management of a U.S. banking office or functionally regulated subsidiary is determined to be less-than-satisfactory, the Federal Reserve's focus as a supervisor is on complementing the efforts of the domestic primary supervisor, functional regulator, or home country supervisor. In doing so, the Federal Reserve will seek to ensure that the FBO provides appropriate support to its U.S. banking offices and does not take actions that may further weaken these operations or its ability to act as a source of strength for these operations.

Beyond the specific activities noted below, these circumstances also may require the Federal Reserve to enhance the activities addressed in section III for understanding and assessing key governance functions, or primary risk management and internal controls. In addition, the Federal Reserve will adjust its supervisory activities as necessary when the combined U.S. operations are in a weakened condition or when there are questions regarding the capabilities of the management for U.S. operations.

*Supervisory activities:*

- **Banking office.** In instances when the condition or management of a U.S. banking office of a large complex FBO is rated less-than-satisfactory, or when the banking office faces financial stress or material risks, the Federal Reserve's primary supervisory objectives as host country supervisor are to ensure that the FBO (i) provides appropriate support to the U.S. banking office and (ii) does not take action that could harm the banking office. The Federal Reserve will work closely with other relevant domestic primary supervisors, functional regulators, and home country supervisors as appropriate to understand whether a nonbank affiliate has contributed to the banking office's weakened condition, and to understand the impact of the banking office on the combined U.S. operations. The Federal Reserve also will communicate with head office management of the FBO to determine if it is providing appropriate support to the U.S. banking office, and will work in conjunction with the home country supervisor to address any concerns regarding the nature and extent of ongoing support provided by the FBO.
- **Nonbank affiliate.** When any U.S. nonbank affiliate of a large complex FBO 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 U.S. banking offices, as discussed above in sections III.A.9 and III.C on, respectively, "Funding and Liquidity Management of U.S. Operations" and "Risk Management and Financial Condition of Significant U.S. Nonbank Affiliates." The Federal Reserve also will take appropriate steps to ensure that any actions taken by the FBO to assist a U.S. nonbank affiliate do not

impair its continuing ability to serve as a source of strength to its U.S. banking offices. The Federal Reserve will coordinate its activities with those of any relevant functional regulator to the extent appropriate.

In cases where there is a likelihood of negative impact on U.S. operations from direct or indirect interrelationships or dependencies with non-U.S. affiliates, the Federal Reserve will work with other relevant domestic primary supervisors, functional regulators, and home country supervisors to plan and execute supervisory activities deemed necessary to address the area of potential negative impact.

#### ***E. Edge and Agreement Corporations***

*Objectives:* Many large complex FBOs 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 supervisor of the FBO's combined U.S. operations.<sup>37</sup> When the Edge or agreement corporation is held by a U.S. bank, the domestic primary supervisor often relies on information provided by the Federal Reserve in developing its own understanding and assessment of the U.S. 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 conduct of its activities as Edge and agreement corporation supervisor with its activities as supervisor of an FBO's combined U.S. operations. 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:

- a) Structure and attributes, including whether the Edge or agreement corporation is a banking or investment organization;
- b) The size, nature, and location of its primary activities, as well as key financial and other trends;
- c) The business lines and risks, and associated trends, of the Edge or agreement corporation's primary activities on a stand-alone basis, as well as their

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<sup>37</sup> The Federal Reserve is solely responsible for approving, and supervising the activities of, U.S. Edge and agreement corporations. As discussed in SR letter 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.

significance to the risk profile of the parent U.S. bank (if applicable) and the combined U.S. operations;

- d) The extent to which risk management and internal control functions are unique to the Edge or agreement corporation, or are shared with the parent U.S. bank or other U.S. operations of the FBO;
- e) Any potential Regulation K limitations or other U.S. compliance issues, and the adequacy of processes to ensure ongoing compliance; and
- f) 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 other U.S. operations of the FBO, and will coordinate fulfillment of the Federal Reserve's responsibilities as Edge and agreement corporation supervisor with execution of its supervision role for the FBO's combined U.S. operations. This strategy will reflect the extent to which reliance can be placed on (i) the Federal Reserve's understanding and assessments of key governance, risk management, and control functions, as well as material portfolios and business lines, for the combined U.S. operations; (ii) assessments developed by the domestic 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 U.S. parent bank; and (iii) findings developed by host country supervisors for activities under their jurisdictions.

In addition, where the domestic primary supervisor of an Edge or agreement corporation's parent U.S. bank relies on the Federal Reserve's understanding and assessment in order to develop its CAMELS rating,<sup>38</sup> the Federal Reserve will work to fulfill that supervisor's information needs.

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<sup>38</sup> 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 letter 96-38, "Uniform Financial Institutions Rating System," and SR letter 97-4, "Interagency Guidance on Common Questions About the Application of the Revised CAMELS Rating System."