TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK

SUBJECT: Supervision of De Novo State Member Banks

Applicability: This guidance applies to all current or potential de novo state member banks and insured depository institutions that are or plan to become member banks of the Federal Reserve System, including those with $10 billion or less in total consolidated assets.

This letter provides guidance to Federal Reserve Banks regarding the supervision of de novo state member banks (de novos), and the evaluation of de novo insured depository institutions seeking to become state member banks. For purposes of this letter, an insured depository institution is considered to be in the de novo stage until it has been operating for at least three years. Further, this letter applies to any commercial bank, thrift, Edge Act corporation, or industrial bank that has been in existence for less than three years and is converting to become a state member bank.

Submitting a De Novo Application

Prior to submitting an application to become a state member bank, an insured depository institution should consult with the applications staff of the Reserve Bank in the district where the de novo would be established. Applicants are required to complete the Application to the Board of Governors of the Federal Reserve System for Membership in the Federal Reserve System (form FR 2083), which is available on the Board’s public website.4

1 With the issuance of this letter, the SR letter 91-17, “Application and Supervision Standards for De Novo State Member Banks,” is superseded.

2 As defined in section 3 of the Federal Deposit Insurance Act (FDI Act), an insured depository institution is any bank or savings association the deposits of which are insured by the FDIC. 12 U.S.C. § 1813(c)(2).

3 Insured depository institutions that are in operation for longer than three years and apply to become a state member bank are not subject to this letter, but may be subject to a pre-membership examination as outlined in SR letter 15-11/CA letter 15-9, “Examinations of Insured Depository Institutions Prior to Membership or Merger into a State Member Bank.”

4 The FR 2083 can be found at the following link: https://www.federalreserve.gov/apps/reportforms/reportdetail.aspx?sOoYJ+5BzDaPiGsI4k8vPzSnAuw4Gwb.
Examination Frequency for De Novos

Within the first six months following a de novo’s formation or conversion to a state member bank, the responsible Reserve Bank should conduct a targeted examination. In a written report provided to the bank’s board of directors and senior management, the Reserve Bank should summarize the scope of review and supervisory findings, but should generally not assign a CAMELS rating.

The responsible Reserve Bank should conduct a full-scope examination, independently, jointly, or concurrently with the state, within 12 months of the de novo’s formation or its conversion to a state member bank. Thereafter, the bank should remain on a 12-month cycle until two full-scope, on-site examinations have been conducted. After the bank (i) has had three full-scope examinations, and (ii) has been in operation for three years, the Reserve Bank may follow the statutorily required full-scope examination schedule.

Examination Scope of De Novos

The initial Federal Reserve examination of a de novo (conducted within the first six months following its formation or conversion to a state member bank) may be targeted in scope to focus on the adequacy of the bank’s risk management process or the management component of the CAMELS rating. Examiners should also review the de novo’s operating results for consistency with its projections and any business and operating plans submitted in connection with its membership application.

After the initial target examination, the next three examinations of the de novo, either led by the Federal Reserve or conducted jointly with the state banking department, should be full-scope. In addition to the supervisory expectations for a full-scope examination, the Reserve Bank should review the de novo for the following items.

- **Tier 1 Leverage Capital.** A de novo should maintain capital ratios commensurate with its risk profile and, generally, well in excess of regulatory minimums. Typically, as a condition of membership, the Federal Reserve requires each de novo to maintain a Tier 1 leverage ratio of at least 8 percent for the first three years of its existence. The Reserve Bank should consult Board supervision staff when the Tier 1 leverage ratio of a de novo falls below 8 percent. Examiners should also scrutinize de novos that rely on additional capital infusions to meet this minimum requirement and understand the stability of the capital source.

- **Capital Distributions.** A de novo should generally ensure that it has sufficient earnings and capital to support its growth projections and any capital distributions, as well as its ongoing capital needs. As a general matter, a de novo should receive two consecutive CAMELS ratings of “1” or “2”, based on full-scope examinations before making such distributions. Further, the de novo’s parent bank holding

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5 Examination frequency expectations for all state member banks rated less than satisfactory are contained in the Federal Reserve’s Commercial Bank Examination Manual.

6 See 12 U.S.C. § 1820(d)(1) and 12 CFR 208.64; see also SR letter 18-7, “Updates to the Expanded Examination Cycle for Certain State Member Banks and U.S. Branches and Agencies of Foreign Banking Organizations.”

7 Refer to 12 CFR 217.10(a). This expectation does not prevent a de novo that is a qualifying community banking organization from electing to be subject to the community bank leverage ratio framework. See also 12 CFR 217.12.
company (if applicable) should assess the risk associated with taking on significant debt that is solely reliant on dividends from the subsidiary de novo to service the debt obligation. This guideline is not intended to discourage dividends used by a parent bank holding company to pay the de novo’s income taxes.\(^8\)

- **Senior Management Officials and Directors.** A de novo should generally consult with the Reserve Bank before the proposed addition of any individual to the board of directors or the employment, promotion, or transfer of any individual as a senior executive officer.

- **Composition of the Board of Directors.** De novos are encouraged to have a board of directors with a diverse and relevant background. Managerial oversight is strengthened overall when a bank’s board of directors is composed of persons with a variety of professional experiences.\(^9\) Further, a de novo should consider having at least two outside directors with prior banking-related experience. However, Board staff is aware that it may not be feasible for all banks, particularly banks located in rural areas, to find outside directors with prior banking experience.

- **Business Plans.** A de novo should have a sound and comprehensive business plan outlining the scope of the organization’s operations during the first three years of existence. The business plan should provide a framework for management to operate the bank during the de novo period. Management should periodically review the de novo’s business plan against actual performance to identify material variances. Under Regulation H, a member bank may not, without the permission of the Board, change the general character of its business or the scope of its corporate powers at the time of admission to membership.\(^10\) As such, before undertaking a material deviation from the bank’s business plan that changes the scope of its business operations, the state member bank must seek the Federal Reserve Board’s approval.\(^11\)

- **Annual Outside Audits.** A de novo that is not subject to Section 36 of the FDI Act\(^12\) should consider engaging an independent public accountant to audit its annual financial statements for at least the first three years of operation.

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\(^9\) De novos that are subsidiaries of bank holding companies may draw directors from the parent bank holding company’s management and board.

\(^10\) Refer to 12 CFR 208.3(d)(2) and SR letter 02-9, “Guidance Regarding Significant Changes in the General Character of a State Member Bank’s Business and Compliance with Regulation H.”

\(^11\) Refer to 12 CFR 208.3(d)(2).

\(^12\) Section 36 of the FDI Act, as implemented by part 363 of the FDIC’s regulations, requires each insured depository institution with total assets of $500 million or more to have an annual audit performed by an independent public accountant. See 12 U.S.C. § 1831m(d); 12 CFR 363.1(a), 363.3(a); see also SR letter 94-3, “Supervisory Guidance on the Implementation of Section 112 of the FDIC Improvement Act.”
De Novo Subsidiaries of Bank Holding Companies with Assets Greater than $3 Billion

This policy applies to de novos that are subsidiaries of existing bank holding companies. A Reserve Bank may, however, elect to make a risk-based determination that a de novo that is a subsidiary of a bank holding company with consolidated assets of greater than $3 billion should be examined less frequently than otherwise suggested in this guidance if, in the opinion of the Reserve Bank, the parent company and its subsidiary banks are in satisfactory condition and the parent is considered to be a source of strength to its insured depository institution subsidiaries. Such subsidiary de novos would be expected to maintain capital levels in conformance with the de novo policy guideline.

For questions regarding this guidance, please contact Laura Macedo, Lead Financial Policy Analyst at (202) 452-5268, Marlon Willis, Senior Financial Institutions Policy Analyst at (202) 973-7394, or Jonathan Rono, Manager, at (202) 721-4568 in the Division of Supervision and Regulation. In addition, institutions may send questions via the Board’s public website.13

Michael S. Gibson
Director

Supersedes:

- SR letter 91-17, “Application and Supervision Standards for De Novo State Member Banks”

Cross References:

- SR letter 18-7, “Updates to the Expanded Examination Cycle for Certain State Member Banks and U.S. Branches and Agencies of Foreign Banking Organizations”
- SR letter 15-11/CA letter 15-9, “Examinations of Insured Depository Institutions Prior to Membership or Merger into a State Member Bank”
- SR letter 02-9, “Guidance Regarding Significant Changes in the General Character of a State Member Bank’s Business and Compliance with Regulation H”